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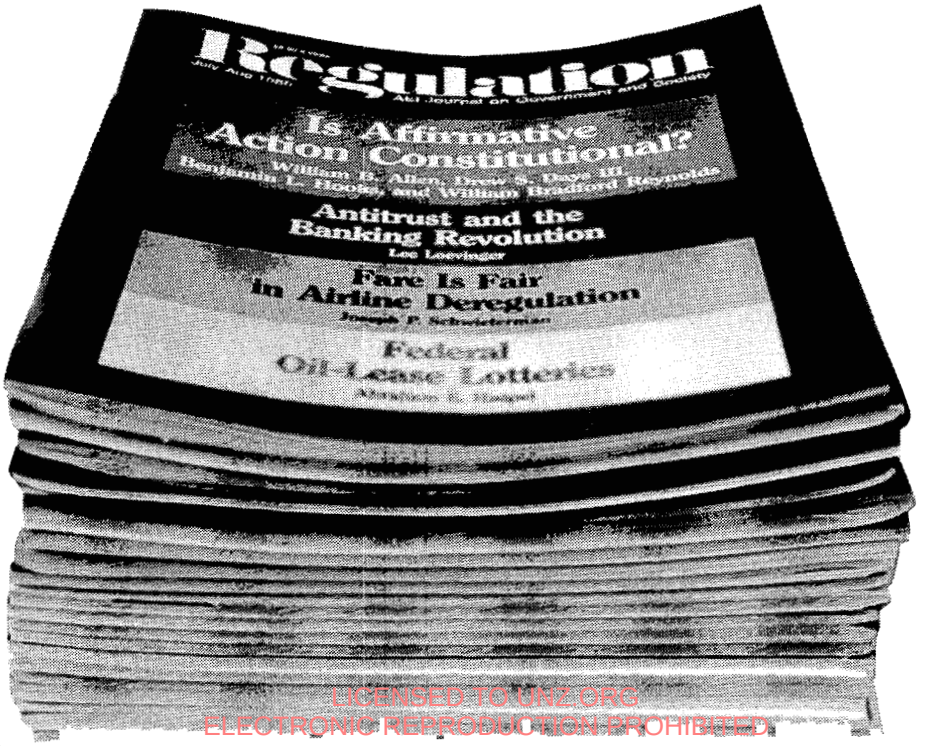

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Regulation

Sept/Oct 1985 AEI Journal on Government and Society

Competition of ideas is fundamental to a free society

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Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Telephones and Computers: Uncrossing the Wires

TO THE EDITOR:

William Baumol and Robert Willig ("Telephones and Computers: The Costs of Artificial Separation," *Regulation*, March/April 1985) have done a commendable job explaining why major changes in the Federal Communications Commission's *Second Computer Inquiry* rules are in order. Those rules essentially require AT&T and the regional Bell companies to separate their regulated "basic" from their unregulated "enhanced" service offerings through separate arm's-length subsidiaries. The rules were designed for a company—the unified Bell System—that no longer exists. They have been kept in place chiefly because AT&T's competitors find change inconvenient.

But the article understates the calamitous consequences of this and related regulatory regimes, particularly for U.S. communications trade. In addition, the authors are far too sparing when it comes to proposing relief. Not only AT&T but a number of other companies similarly constrained should be freed from this regulatory bondage.

Regulators of multi-product firms face a perennial problem: by misattributing costs, a company can use monopoly rents to subsidize enterprises that compete on the open market. In the early seventies, the FCC embraced the notion that requiring companies to maintain separate subsidiaries was a sort of universal panacea for these cost-accounting problems. The 1934 Communications Act, however, gives the FCC explicit authority to prescribe industry accounting practices. Accounting is one of the chief glues that holds our economy together; as a group, accountants manage to reap some $14 billion in revenues annually, which suggests that what they do has some merit. But for years the FCC has held the view that in telecommunications, accounting just will not work.

At the same time, rooting out and eradicating any chance of cross-subsidies has become something of an FCC obsession over the years. Now, as a practical matter, cross-subsidies pervade American business life quite as much as stock options, worries about Japanese competition, white wine, and aspirin. Probably no company ever earns precisely the same return on each part of the repertoire of services it provides. Indeed, to require every service from the outset to float on its own fully distributed cost bottom would be an effective way to suppress new offerings.

Not all the things people worry about, however, are necessarily rational. Pre-revolutionary Chinese peasants worried about the people who might be trespassing on their land—from below, on the other side of the world. Businessmen faced with price competition often worry just as much about the possibility that their competitors might be cross-subsidizing. Thus many of the telephone industry's competitors, as well as the FCC itself, react to the mention of possible cross-subsidies as if one had tossed an especially realistic rubber tarantula onto the policy-making table.

If the FCC's requirement of separate subsidiaries was ever justified, however, it is hard to see how it makes much sense today. This sort of official handicapping of established telephone companies has the obvious result of shielding such firms as IBM from competition by new entrants.

Consider, moreover, how these and related rules affect international trade. In practice, the effect of the present FCC requirements is to force all "intelligence"—capabilities beyond simple telephone service—out of the national telephone network and into the switching and other equipment located on a subscriber's premises. Since foreign vendors supply a far larger share of customer-premises equipment than of network equipment, they greatly benefit from this arrangement.

The trade statistics tend to bear this assumption out. In 1982, the year that the AT&T divestiture was announced and a little more than two years after the FCC's computer rules became effective, the United States ran a $200 million trade surplus in telephone equipment. Thereafter we ran a deficit of $419 million in 1983 and $1 billion in 1984. In the broader category of "electronics-based products," things were considerably worse. Between 1982 and 1984 our trade balance shifted from a surplus of $4.9 billion to a deficit of about $6.2 billion. If one uses the semi-official multiplier by which every $1 billion in electronics trade supports about 25,000 high-tech workers, this means that in only about two years, we lost some 278,000 American jobs.

FCC restrictions obviously were not the sole cause of this small national calamity. Regulations imposed by the Justice Department's Antitrust Division and a stronger American dollar also contributed. Unless we want to see our "sunrise" telecommunications sector eclipsed, however—before it has even risen—we are going to have to do something to reduce the level and intensity of domestic regulation of our telephone industry generally.

Which brings me to my second point. It is not simply AT&T that should be allowed to compete more effectively both at home and abroad. The same is true of the seven regional Bell holding companies, which at present are not only subject to the FCC's *Second Computer Inquiry* rules, but must also contend with the severe restrictions that the Antitrust Division is enthusiastically enforcing as it administers the AT&T consent decree. Then there is the GTE Corporation, the second largest phone company. Although largely exempted from the FCC's rules, GTE is subject to yet another Antitrust Division consent decree, one effect of which is to hobble *this* possible competitor.

AT&T presumably finds this situation not unattractive because it hampers most of that firm's large potential competitors. But why is it in the national interest for the government to ice down fully half our telecommunications industry at pre-

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cisely the time that the international competitive challenge is highest?

The policy of the past decade seems to rest on the assumption that America's telecommunications companies are so large, their resources so great, that they can put up with pretty much anything that the federal bureaucracy wishes to visit upon them. We ought to wake up, however, to the obvious fact that the U.S. industry no longer stands like some economic Gulliver astride a world of communications Lilliputians. The more burdens and impositions placed on American telephone companies, even for the most commendable of reasons, the less likely it is that the industry will be able to provide efficiently the future jobs and investment opportunities that the country needs. In breaking up AT&T while retaining outmoded regulatory restrictions and adding new ones, we may, in effect, have simply swapped the "dead hand of monopoly" for the dead hand of excessive federal regulation. That exchange does not do the country any good in the long run.

Kenneth Robinson,
National Telecommunications and Information Administration

Comparing Kiwis and Oranges?

TO THE EDITOR:

I was disappointed that *Regulation* gave so much space to Thomas Lenard and Michael Mazur's attack on citrus marketing orders ("Harvest of Waste: The Marketing Order Program," May/June 1985). In this imperfect world, I believe those of us who are truly concerned about government interference in our lives should direct our energies to where the harm is most egregious and where established relationships can be dismantled without excessive harm to innocent parties. Citrus marketing orders are *de minimis* as a form of government control. They do not even use tax dollars. They merely permit the citrus industry to estimate the amount of fruit that can be absorbed by consumers each week and then "prorate" each grower's share of the amount shipped, so as not to glut or short the market.

Under the marketing-order system, consumers have enjoyed a steady supply of fresh fruit at relatively stable prices that at times have been lower than the prices of potatoes or onions. In the last thirty years the total navel orange crop has increased from 29,000 rail carloads (a carload is 1,000 40-pound cartons) to an anticipated 57,700 carloads this year. During the same period, domestic fresh shipments more than doubled and exports nearly tripled. Although the size of the crop has been as small as 15,300 cars in the 1961–62 freeze year and as large as 84,200 cars three years ago, California and Arizona citrus farmers are thriving at a time when most American farmers' livelihoods are being undercut by spiraling production costs and declining market prices.

As it is, the present system is remarkably close to the free market. In the first place, the market is always competitive in that the price is never fixed and the handler must hustle to find a produce buyer. Although the system evens out returns to growers over time, it guarantees them nothing in the way of profits —which, of course, depend on each grower's costs. Some growers have gone out of business historically and some will go out of business in the future because *in the long run* marketing orders operate similarly to the free market with respect to the allocation of resources.

Getting rid of marketing orders would not take citrus growers much closer to the benefits of the free market than they are now. Growers would be forbidden by antitrust law to band together to establish their own prorate—a prohibition that is contrary to the basic philosophy of free enterprise. In addition, they would still face any number of departures from the free market in the form of agricultural labor laws, environmental legislation, tax provisions, immigration policies, foreign restrictions against imports, and a host of other rules that interfere with individuals' ability to make their own judgments and act on them (*without force or fraud*, of course).

There is absolutely no doubt that in the absence of marketing orders many small farmers, who are not inefficient but who simply lack economic staying power during times of rock-bottom prices, would go out of business. The reason is that farmers are not part of the negotiations on the price of the crop. It is the handlers who negotiate the price; the return the farmers receive depends on the price that the handlers receive.

With a drop in the number of producers, orange prices would go up—and oranges are not a luxury fruit like kiwis or cherimoyas but one of the three fresh-fruit staples in the American diet (the other two being apples and bananas). After four-plus decades of marketing orders, consumers have gotten used to having fresh oranges all year round at reasonable prices. If foreign citrus came into the U.S. marketplace to fill the void, consumers would not only have to accept an inferior product (California eating oranges are of the very highest quality) but would be dependent on foreign sources for both bananas *and* oranges. Many Americans who defend the Jeffersonian view that there is value in being a nation of small farmers do so because they feel uncomfortable at the thought of having staples of our food supply in the hands of an American oligopoly or foreign sources.

The optimistic predictions that orange prices to consumers would drop if marketing orders were lifted have turned out to be based *more on theory than reality*. When the Department of Agriculture suspended the prorate volume restrictions on navel oranges in January of this year, the price to the grower dropped by almost 30 percent in five weeks, but there was little or no change in the price consumers paid for oranges at the local supermarket.

Lenard and Mazur's article contains many inaccuracies. I will cite just three.

(1) In discussing the fresh-fruit and juice markets, they say that "identical products are sold for different prices." Wrong. It is the less attractive fruit that goes to juice. The best is sold for eating fresh.

(2) They say "oranges are diverted to juice when consumers would rather enjoy them fresh." This makes no sense because it does not tell us under what circumstances and at what price consumers manifest this preference. It also makes *no sense since the growers push to* sell to the fresh market where returns are higher. There is virtually no incentive to put navel oranges into juice since, in almost all years, *all* can be sold at the higher fresh-market price.

(3) The authors say, "prorate and market allocation provisions are used in good and bad years alike—suggesting that their purpose is simply to raise prices, not smooth them out." Orange prorates do not attempt to smooth out prices from one year to the next, but only during a given season, whether for navels or for valencias. In fact, prorates are among the most sensitive of the instruments imaginable for this purpose:

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- The amount that goes to market each week is set in simple response to demand. So if a supermarket produce buyer wants to do an orange promotion, he can easily convey that information and get the additional fruit he wants.
- Shippers faced with an unusual opportunity to sell more fruit than their allowance can borrow against future allotments.
- There are no limits on the amount of fruit that can be sold fresh for export or for juice or given away as charity.
- Every season the prorate is suspended when 85 percent of the crop has been sold. The suspension of the prorate in January because of short supply was based on a similar rationale.

Citrus marketing orders, far from being the villain Lenard and Mazur make them out to be, have served both producers and consumers. The system has worked so well that some agricultural economists are considering marketing orders as a replacement for the costly and unworkable subsidies, acreage allotments, price supports, and other schemes that characterize much of the rest of U.S. agriculture.

Clytia M. Chambers,
Hill & Knowlton, Inc.
Los Angeles, California

MICHAEL P. MAZUR responds:

My article with Thomas Lenard argued that citrus prorates encourage overproduction, raise prices and restrict supplies to consumers of fresh fruit, artificially expand sales to processors, lower the average quality of fruit, and lead growers to abandon crops in the field. All of these distortions will occur in the long run as well as the short. Our article suggested that these effects are costing the U.S. economy more than $100 million a year. Yet Clytia Chambers says that prorates are a "*de minimis*" deviation from the free market. I wonder what she would consider a major deviation.

Chambers believes that it is consistent with the basic philosophy of the free market for sellers to collude to restrain competition among themselves. This is obviously a point on which we differ. In any event, marketing orders do permit conduct that if engaged in by sellers elsewhere in the economy would land them in prison under the antitrust laws, and to that extent they are consistent with her views. Marketing orders go further than just suspending the antitrust laws, however, since they effectively give a majority of growers the legal authority to compel the unwilling minority to participate in their scheme.

The data do not support Chambers's assertion that there was little or no change in consumer prices of navel oranges after the prorate suspension announced in January and put into effect on February 7, 1985. According to the Bureau of Labor Statistics, the average retail price for navel oranges declined from 52.6 cents per pound in January to 52.5 cents in February and 50.5 cents in March, a decline of 3.8 percent from the last month entirely under the prorate to the first month entirely under the suspension.

Concerning the three alleged inaccuracies, I would observe the following:

First, our article indicated that the fruit sent to the fresh market is of better quality on average than that sent to the juice market. Our point is that fruit of a given quality sells at a higher price in the fresh market than identical fruit can fetch on the juice market.

Second, *in the absence of prorate* there would indeed be very little incentive to put navel oranges into juice and most would probably be sold to the fresh market. As a result of the prorate, however, more than 30 percent of navel oranges marketed during the five seasons between 1978 and 1983 were sold for processing.

Third, proponents of marketing orders often attempt to defend them as devices to stabilize prices from year to year as well as from week to week. Our article addressed both contentions. The argument that federal regulations must mandate the amount shipped to market each week, lest growers ship too much one week and too little the next, ignores the fact that the free market gives growers ample incentive not to act that way. That the market actually works is demonstrated by the shipping performance of other citrus crops not subject to prorate. Moreover, a recent statistical analysis by the Economic Research Service of the U.S. Department of Agriculture found that week-to-week variability in prices and volumes shipped was no greater during the 1985 suspension of the navel orange prorate than during the preceding five years under the prorate.

On a different matter, I am happy to report that our article was overly pessimistic about the prospects for reform of the hop marketing order. On July 1 the Department of Agriculture announced that it would terminate that marketing order, effective December 31 of this year.

Competition in Transatlantic Satellites

TO THE EDITOR:

Peter Cowhey and Jonathan Aronson's intriguing analysis of the controversy over separate transatlantic satellites ("The Great Satellite Shootout," *Regulation*, May/June 1985) incorrectly concludes that "both Intelsat and Orion have won." In fact, the Federal Communications Commission's (September 3, 1985) decision to allow new satellites may have left both Intelsat and Orion losers while dealing the winning cards to European governments.

Intelsat might claim that the decision was a victory in that the U.S. government did acknowledge its legal obligations under the Intelsat agreement and consequently banned switched-network (telephone system) use of the new satellites. It also imposed a one-year minimum lease restriction on separate satellite systems. However, it placed no limit on the number of systems that could be licensed, the types of services separate systems could offer, the degree to which multiple related or unrelated users could share a given system's facilities, or the minimum capacity that could be allocated to any one user under such a sharing agreement. And even if the FCC's minimal restrictions effectively shield a "core" of switched services from the competition of separate satellites, Intelsat will come under across-the-board pressure in that area too because of the FCC's unrestricted licensing of new transatlantic fiber-optic cables.

The FCC urges Intelsat to respond to this pressure by increasing its efficiency and reexamining its capacity plans. To heed this call for more "business-like" operations, Intelsat will have to reexamine and modify its nondiscriminatory pricing structure, its broad-beam technology aimed at linking a maximum number of earth stations through a single satellite, its user-cooperative model capital structure, and its complex international-organization management system.

Unfortunately, the factors that inhibit Intelsat's competitive poten-

(Continues on page 43)

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Perspectives
on current developments

One Share, One Vote, Forever?

A Securities and Exchange Commission study released in October suggests that when corporate managements adopt "takeover defenses" to ward off potential raiders they often are harming the stockholders they are paid to represent. The study found that when companies changed their charters to stagger the expiration of directors' terms or to require that any sale of the firm to outsiders be approved by two-thirds of the stockholders, their stock values dropped by 2 to 3 percent on average. Overall, the SEC staff found that the adoption of such "shark repellents" was linked to an average 1.31 percent drop in stock prices.

If the SEC figures hold up, they would seem to indicate that the effect of many takeover defenses is to entrench current management at the expense of shareholders. As it happens, a number of other researchers have found that such defenses have no effect on stock prices one way or the other. (No one has found that takeover defenses actually enhance stock prices, as one might expect them to do if they succeeded in their apparent purpose of protecting stockholders from impulsive actions they might later regret.)

There is what might be called an if-you-can't-beat-it-join-it solution to the problem of management's yen for independence from stockholders. It is for a firm to separate its stockholders into first-class and second-class compartments, by issuing "Class A" shares that carry a full right to vote at annual meetings and "Class B" shares that either lack a vote or hold only diluted voting rights—say, one-fifth of a vote per share. This is far from a new idea. A number of prominent companies, including those that publish the *Washington Post* and *New York Times,* have long maintained split voting arrangements of this sort. But they have also been the rare exception, with the rule among large corporations being the familiar arrangement of one stockholder, one vote.

A major reason for this uniformity is that for the past sixty years the New York Stock Exchange has required all companies to adopt a "one-share, one-vote" rule as a condition for being listed on the exchange. Companies with differential voting rules have had to settle for listings on the American Stock Exchange, as have the *Times* and the *Post,* or the over-the-counter market, as have shoemaker Nike, Inc., and the Coors brewing company. Now, in part because deregulation has spurred new competition between stock exchanges, the situation is changing, with the most likely result being that NYSE will admit companies with split stock unless Congress decides to ban the practice.

In recent years there has been a strong trend for managements to create innovative stock categories. A notable example is General Motors, which, as part of its acquisitions of Electronic Data Systems and Hughes Aircraft, created "E" and "H" shares each of which entitles its owners to half a vote. The more common motive for creating split stock classes is to ward off potential takeovers or loss of control by a leading family. Among well-known firms that have proposed creating new categories of stock for this reason are Dow Jones and Hershey Foods. In the past, the disadvantages of losing the prized NYSE listing would have discouraged most companies from trying such maneuvers. That has changed as more effective competition from other exchanges and from the over-the-counter markets has made it easier for companies to establish a market in their stock off the Big Board. None of its competitors among securities markets maintains as strict a prohibition on unequal voting rights as the NYSE does. The American Stock Exchange allows split voting rights so long as companies meet certain requirements, such as a voting differential between shares that does not exceed ten to one. More than fifty firms with

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dual classes of stock are currently listed on the Amex. More than a hundred other dual-stock companies trade on the National Association of Securities Dealers' over-the-counter system, NASDAQ.

The NYSE always failed to recruit certain listings because of its strict standards. In the early 1980s, however, there suddenly arose the prospect of significant defections from its own ranks of listed firms. The first few NYSE companies that issued second voting classes of stock were promptly delisted, but the exchange soon realized it had a trend on its hands, and it decided to suspend a number of ongoing delisting proceedings and form a subcommittee to review the rule. (In the meantime, GM's E stock and some others are being traded.) In early January of this year, the exchange's review panel issued a report citing the growth of competition in the market for the listing of securities and recommending that the exchange liberalize its standards. The liberalization would involve allowing firms to issue a second class of common stock so long as they met certain conditions, including approval by at least a two-thirds majority of original stockholders and by a majority of outside directors, and a voting differential not exceeding ten to one.

But there was a big *if*: the liberalization should proceed only if the Securities and Exchange Commission did not decide to impose uniform listing standards on all securities markets. What the NYSE panel really had in mind was for the other securities markets to tighten their own standards, either voluntarily or by regulation, so as to end competition between the exchanges along this dimension. The Amex has also gone on record in favor of such a settlement, but the NASD and especially its member firms have been more skeptical.

The securities markets are currently soliciting comments from their participants in order to decide how to proceed. The SEC, for its part, has been dragging its feet on the issue, one reason being that it is not sure it has jurisdiction to order any action in this area. The academic and business communities appear to be split on the issue. But many members of Congress seem to be enamored of the one-share, one-vote system and are expressing impatience with the SEC's inaction and the securities industry's failure to reach an agreement. In late May the House Subcommittee on Telecommunications, Consumer Protection, and Finance held hearings, and on June 18 twin bills were introduced in the House and Senate that would amend the Securities and Exchange Act of 1934 to make it illegal for companies to offer common stock with differential voting rights. The sponsors are Representative Dingell (Democrat, Michigan) and Senators D'Amato (Republican, New York), Metzenbaum (Democrat, Ohio), and Cranston (Democrat, California). This congressional pressure may herd the industry into a "voluntary" agreement to require all listed firms to adopt a one-share, one-vote structure.

The fundamental problem with most "shark repellents" is that they take away sovereignty rights that stockholders have been promised and indeed have bought and paid for. True, the shareholders usually cast a one-time vote to approve the shark repellent itself, but in a single quick balloting it is all too possible that inattentive investors will be bulldozed by management and the proxies it holds. That might be how the stockholders of firms studied in the SEC report came to approve measures that made their holdings less valuable.

When a company issues a new line of nonvoting stock, on the other hand, the buyers know what they are getting into, and expect to pick up the stock at a discount that reflects their shares' lack of an equal voice in corporate affairs. That this discount exists is very likely, although its size is a matter of controversy. In a 1982 *Journal of Finance* article, Haim Levy found that in Israel, where split voting rights are common, investors paid an average 45 percent premium for voting stock. Ronald Lease and others, in a 1983 *Journal of Financial Economics* article, found a much smaller average premium among U.S. companies—only 5.4 percent.

What the purchasers of nonvoting stock are doing is "unbundling" the right to participate in the firm's expected prosperity from the right to control its course. This combination of features may actually be highly attractive to some investors: if they lack the means to follow the affairs of the companies they invest in, they may be happy to trade their voice in management for a slightly higher return. The original group of shareholders, those who retain full voting rights, get a different bargain: though it costs

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them slightly more to raise equity capital for their firm, they can better retain control of it.

Nonvoting stock thus occupies a niche in a continuum of securities between bonds and ordinary preferred stock, on one hand, whose owners have no voice in management decisions and can look forward to no increases in their interest or dividend income if the company prospers, and common stock, on the other, which has both voting rights and participation in growth prospects. In the middle ground, along with nonvoting stock, are warrants and "convertible" varieties of bonds and preferred stock, whose market value fluctuates in sympathy with that of the common shares into which they can be converted, but which have no vote unless they are so converted. These other securities formats, like Class B stock, make it possible for investors to speculate on the future prospects of the firm without buying immediate voting rights. But no one objects to them on that account. For that matter, ordinary minority investors in companies controlled by a single stockholder or family find themselves in much the same position as owners of nonvoting stock.

There is, however, one case in which split stock issuance can endanger stockholder rights. That is when the newly issued shares are "superior" rather than "inferior," having voting rights that are greater than, rather than less than, those of existing common stock holders. If current stockholders are not paying attention, they may "approve" a plan under which superior stock is awarded preferentially to management or other insiders for inadequate consideration. Some companies have avoided this danger by issuing superior stock equally to all holders, as a stock dividend, with the twist that the superior stock can be converted to ordinary stock, but pays no dividend until it is converted. This strategem gives ordinary holders a big incentive to convert their shares voluntarily to get the extra dividends, while insiders can choose to forgo dividends in exchange for more voting rights. The strategem in effect pays minority stockholders to accept dilution of their votes, rather than forcing them—which seems fair enough.

One of the amusing sidelights of the issue is its possible effect on prominent newspapers. The people who own controlling blocks in large newspaper companies naturally claim that their motive in issuing inferior stock is the high-minded one of guaranteeing the independence of their papers against outside buyers who might have an axe to grind. This prevents the Rupert Murdochs, Mort Zuckermans, and Ted Turners from using "raids" to expand their media empires—which is fine with most media critics, for whom the more newspaper independence from entrepreneurial oversight, the better. But although the Dingell-D'Amato bills might make some well-known newspapers nervous for their future independence, any attempt to give newspapers a special exception would open Congress itself to the charge of unequal treatment.

The final irony is that for Congress to abolish experimentation with this device of corporate governance would probably divert managerial self-preservation efforts back into channels that are likely to be more harmful to shareholders. Much as the Environmental Protection Agency has been blamed for banning the least toxic of alternative pesticides, so Congress may be about to ban the most innocuous "shark repellent" in the seven seas.

Urban Decay, Regulatory Sprawl

Somewhere Friedrich Hayek has written that it is impossible for government to control just one thing. Once the side effects, omissions, and unintended consequences of its first regulation become apparent, the state must resort to another and then another—if, that is, it is still intent on pursuing its original goal.

That regulations, like potato chips, cannot be consumed singly is nowhere illustrated better than in New York City's rental housing laws. By now just about everyone is familiar with the landscape (or moonscape) of New York housing after forty years of rent controls: the chronic shortage of vacant apartments, the halt in new construction of private rental units, the decline in the quality of New York housing to an average far below that of other American cities, and, during the 1970s, the abandonment of nearly 40,000 units a year. What is less widely appreciated is that the law itself is almost constantly changing and expanding, that new statutes have proliferated as fast as new slums, and that Gotham's judicial dockets have gotten as crowded as its apartment waiting lists.

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The larger the displacement of permitted rent levels from market rent levels—and differences of $1,000 a month are by no means unheard of—the greater is the sort of hydraulic pressure that the market exerts to redress the balance through competition between tenants, withdrawal of capital by landlords, and so forth. This pressure breaks out in a hundred different leaks or tributaries that must each be dammed with a law if tenants are to receive the boon that was originally contemplated.

For example, the right to live at a below-market rent is on shaky ground if one's landlord can bestow it on someone else at will. Thus—in one of the simplest but most far-reaching results of controls—landlords in New York have lost the age-old right, which is taken for granted most places, to reclaim their property when the lease runs out. City law provides that if a tenant wants to go on living in an apartment, the landlord cannot refuse to renew his lease when it expires. And although there are still a few exceptions to this rule, the list is small and shrinking. Chronic lateness in paying rent, for instance, is not a valid ground for nonrenewal. Nor may a landlord refuse to renew a tenant's lease because he wants to move into the apartment himself, except in some cases where his need is "immediate and compelling," and often not even then. A landlord may ask permission to refuse to renew leases if he wants to tear down the building, but it is seldom granted, even when he wants to put up a replacement that would house many more people.

Or take the fundamental issue of "service." It does not mean much to control rents if landlords are free to reduce the services they provide. In order to define and control reductions in service, however, the city has had to wade into a morass of details on such matters as intercom service, the size of post boxes, the frequency of garbage collection, and so forth. This is distinct from another large set of rules that require landlords to provide various services (smoke detectors, secure common doors) whether or not they may have supplied them in the past.

But rules on service quality are at best partly effectual, because not every aspect of service can be quantified. A landlord may be forbidden to reduce a doorman's hours, but there is nothing to stop him from hiring the surliest and least attentive doorman willing to take the job. He may be forced to paint every three years, but not to use quality paint or appealing colors; to provide lobby furniture, but not to make it attractive or comfortable. Thus a building's gross physical attributes can remain intact while its general atmosphere gradually declines to that of a barracks or reformatory.

This is important because of the peculiar incentives for landlords to be obnoxious under rent control. Not only has a landlord no incentive to provide amenities, since hundreds of applicants are waiting to take the apartment if the tenant leaves; worse, he has an actual incentive to provide disamenities, because he wins the right to a special rent increase when someone leaves, along with other sorts of flexibility as well (the effect is to shift the cost of maintaining buildings to newcomers, who are not well-organized politically). So while in most cities frequent tenant turnover is the gravest threat to a landlord's profits, the New York landlord has an actual interest in driving his tenants out—even if he happens to like them personally. This has led to celebrated instances of harassment of tenants by landlords, which have in turn spawned more city laws and regulations. Landlords have responded by pursuing forms of harassment that are difficult to prove as such, including hiring rock bands to perform at odd hours and—in one memorable case—offering to set up a shelter for the homeless in one part-occupied building. The rigors of the city's housing laws are sometimes thought necessary to cope with the unusual perfidy of its landlords, but in fact the would-be reform program may be responsible for much of the misconduct.

In order to increase turnover, landlords have an incentive to enforce lease terms as strictly as they possibly can, even in cases where the tenant has broken only the letter of the lease and has not really harmed the landlord's interests in any direct way. The state and city have responded to this problem by, in effect, legalizing most lease violations, or at least those that do not harm the interests of other tenants. First, the authorities have banned as unenforceable, or restricted the enforceability of, a long list of lease provisions that prohibit such things as pets, unrelated roommates, and business use of the home. Furthermore, a recently passed law provides that even if a land-

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lord goes to court and proves that the tenant has broken a lease, the tenant can avoid eviction simply by showing that he has corrected the violation. Should the violation mysteriously reappear the next week, the landlord is free to call his lawyers and begin the process again.

One facet of the housing situation that appears to be unique to New York, rather than an inevitable outcropping of the rent-control system, is the unusual difficulty of evicting a New York tenant even for the bedrock offense of refusing to pay his rent at all (as opposed to being late). In 1972 the city established a system of housing courts under which a landlord who seeks to evict a tenant for nonpayment must first correct all ongoing violations of the city's habitability code. The idea was to force landlords to fix up their properties, but it did not work out that way. Buildings in the more dilapidated neighborhoods commonly suffer from plenty of code violations, and many owners would sooner abandon their buildings than inject the subsidies needed to bring them up to code. Moreover, tenants can if necessary create last-minute code violations themselves. In this way whole groups of tenants, especially those with good legal-aid representation, have succeeded in carving out rentless lives for themselves through informal ententes in which they agree not to press code violations and the landlords agree to let them stay without paying rent. By the late 1970s, according to Peter Salins's landmark book *The Ecology of Housing Destruction*, 10 percent of the citywide rent roll was delinquent, even though perhaps half the delinquent tenants were getting rent subsidies from the city that covered the entire amount of their rents.

Let it not be said, however, that New York does nothing to combat the anti-social proclivities of its tenants. It is quite severe on several categories of offenses that tenants commit against each other. Take, for example, a widow who has lived in an eight-room flat on the East Side for forty years and pays $200 a month in rent. She is tempted to move to smaller quarters in Florida, but that would mean abandoning an asset worth, in lump-sum terms, hundreds of thousands of dollars. The logical and lucrative thing for her to do is to find a new tenant willing to pay market rates to live in Manhattan, and then either sublet the apartment to him, pocketing the difference, or simply sell ("assign") him the rights to the existing lease for some fabulous sum. A few years ago a court declared that sublets and assignments of this sort were perfectly legal, but the state legislature overruled the court, and landlords are now allowed to prevent all assignments and many sublets. The new law benefits landlords to some extent, since some existing tenants who are denied the chance to sublet at a profit will simply leave instead, but its major effect is to hold down rents for prospective tenants.

In terms of economic efficiency, sublets and assignments have at least one virtue, which is that they allow the unit to go to the tenant who places the highest value on it. But in terms of city politics, they do two unforgivable things. One is to make explicit the extent to which landlords have been expropriated. It is one thing for the widow to enjoy her hundred-thousand-dollar asset quietly in the form of housing, but quite another to attract critical attention by enjoying it openly as cash income.

The other vice of sublets and assignments, as they relate to city politics, lies in rewarding people who move out of New York. And the city goes to considerable lengths to make sure that the benefits of its controls do not flow to those who cannot display due gratitude in the form of votes and taxes. Under a recent directive of Mayor Koch, persons who maintain their tax residence outside the city have been stripped of their right to retain rent-controlled apartments in the city.

Our widow, then, like the Mexican peasant on his *ejido*, is permitted to reap the benefits of land expropriation only at the cost of being effectively bound to the land. The only way she can bequeath the value of the tenancy to her children is to invite one of them to move back in with her. It is quite legal for rent-controlled units to be handed down in this way from generation to generation, world without end, so long as the heirs can claim to have been staying with the deceased for six months to a year before their deaths. Of course, since children have learned of the fortunes to be made in this way, one of the traditional ways of finding a vacant New York apartment—perusing the obituaries—is losing some of its efficacy.

Suppose, however, that none of the widow's children is available to move in with her. Then she is faced with losing the entire capital value of the tenancy to some complete stranger

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(the next tenant to come along) either immediately or at her death. And while she stays, the apartment is of much less value to her than it would be to someone else. With these incentives, she would almost certainly profit by striking some sort of deal with the landlord in which he would pay her to vacate.

The city has made most such deals illegal, which is not surprising, since they reward both landlords and emigrants at the expense of potential rent-controlled constituents. Some landlords ignore the law and offer tenants bribes to move out, but they often find they have no recourse if the tenant pockets the money and then refuses to leave, since illegal contracts are unenforceable.

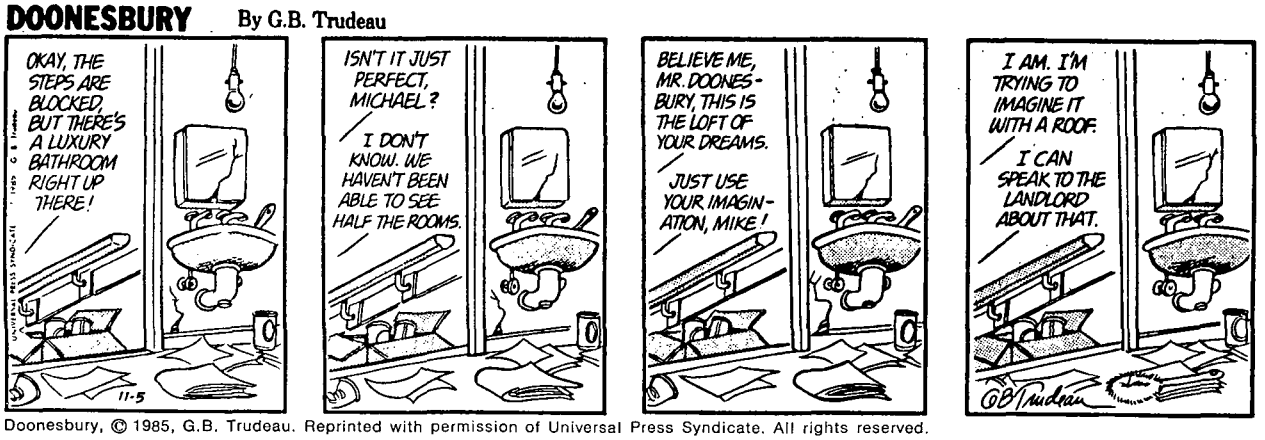
While it is illegal for a landlord to bribe tenants retail, it is still okay to do so wholesale, a building at a time. This is done not by converting buildings into condominiums—those have a reputation as excessively capitalist, and the city has effectively banned such conversions—but into cooperatives. Progressive New York policymakers have still not gotten over their original idea that cooperative forms of ownership are good, and ought to be encouraged to replace private ownership. This lingering sentimentality has created an invaluable escape hatch for the besieged rights of property: a landlord can extract some money from his building by turning it over to a tenants' cooperative at a concessionary price. In the example above, our tenant might buy the unit from the landlord as a co-op for $70,000 and then resell it the next week for $150,000, pocketing the extra $80,000. (Courts have upheld tenants' right to "flip" their apartments in this way.)

As time goes on, however, and city officials have sensed that co-op conversion is being used for purposes they never intended, they have begun to encrust it in turn with more and more legal barnacles. When a co-op conversion is pending, for instance, landlords have an incentive not to rent out any apartments that open up, so as to keep to a minimum the number of people they will have to pay off later. The city has responded by passing a law that makes this sort of "warehousing" a crime for which landlords can be sent to jail.

The co-op exception is one of two loopholes used aggressively by landlords in recent years. The other is a clause allowing landlords to recover the cost of substantially renovating vacant units. When it became clear that the city could not effectively audit claimed renovation expenses, a great many landlords began using inflated expense claims to achieve effective vacancy decontrol—which, along with waves of co-oping, has led to an actual boom in many once-marginal neighborhoods.

Those buildings that are not headed toward renovation or co-op conversion are very often headed toward a quite different fate, the *in rem* rolls. Many an owner hangs on to a building with negative cash flow because of tax advantages. But at some point the building starts losing so much money that the landlord simply walks away. After a certain interval the city takes over the building for back taxes, tenants and all. (The legal proceeding is styled *in rem*, a Latin phrase meaning that the city proceeds against not the owner but the building itself, but the phrase has acquired a life of its own, so that when a building's back taxes get paid off the locals speak of it as being "out of rem.")

By early 1984 the city had in this way acquired more than 120,000 units, 46,000 of which were occupied, on top of 166,000 units of regu-


DOONESBURY By G.B. Trudeau
OKAY, THE STEPS ARE BLOCKED, BUT THERE'S A LUXURY BATHROOM RIGHT UP THERE!
ISN'T IT JUST PERFECT, MICHAEL?
I DON'T KNOW. WE HAVEN'T BEEN ABLE TO SEE HALF THE ROOMS.
BELIEVE ME, MR. DOONESBURY, THIS IS THE LOFT OF YOUR DREAMS.
JUST USE YOUR IMAGINATION, MIKE!
I AM. I'M TRYING TO IMAGINE IT WITH A ROOF.
I CAN SPEAK TO THE LANDLORD ABOUT THAT.
11-5
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lar public housing. Among them are many occupied single-family houses that have been forfeited to the city for back taxes, fixed up, and then rented back to the former owners for sums that, depending on the occupants' income, can be less than the monthly gas bill.

As of 1983, the *in rem* program was costing New York $150 million a year. The city once tried to stem its losses by raising rents to tenants, but a lawsuit by legal-aid lawyers put an end to that. New York's powerful housing activist groups welcome the program as "do-it-yourself" public housing and are demanding that the city speed up its rate of seizures, to which City Hall has responded that it is seizing as fast as it can.

In less progressive localities, properties that are forfeited for back taxes get auctioned off to new owners. New York City occasionally expresses interest in doing this, but the ever-vigilant activist groups have almost always managed to block the sale of occupied buildings. Selling such buildings for immediate renovation is not permitted because that would involve displacing the existing tenants. But anyone who bids for such a building without disclosing plans for renovation is liable to be suspected of the sin of "speculation" (and perhaps rightly, since if he were willing to go on running the building on the old basis he would presumably encounter the same laws that drove the old owners out of business). The other alternative is to hand over the housing to tenant or housing-activist groups for free, a proposition for which there is considerable political support. Incidentally, local activist groups until recently even managed to block proposals to let renovators buy *vacant* properties from the *in rem* rolls, on the theory that to do so would harm local residents by driving up property values in the neighborhood, and that someday the city will have the money and inclination to rehabilitate the vacant units into public housing.

In addition to co-ops and renovations, many other sectors of the New York real estate market have thrived by escaping controls. For many years the shortage of rentable housing in Manhattan drove adventuresome souls to rent factory and warehouse space ("lofts") which they converted to living areas despite laws against residing in industrial structures. Buildings with fewer than six units were also exempted from controls, as were some units owned by nonprofit entities like universities. Office and retail space has long been rented on an open market, and the latest in a series of commercial building booms is under way.

The dynamics of New York housing politics presses ceaselessly for the abolition of all these exemptions. The loft dwellers became powerful enough that the city legalized their dwellings in order to bring them under rent regulation—an action that succeeded in stopping the loft boom. It also extended controls to cover nonprofit landlords, and housing activists are now demanding controls on small buildings and commercial rent controls. For cities like Washington and Los Angeles that are just now starting down the road of rent control, there is a message: the road is long and winding and has no end.

Labor's War on "Double-Breasting"

Much is made in discussions of American labor law of the analogy between regular democracy and worker democracy: just as citizens vote to determine who will represent them in Congress, workers vote to determine which union (if any) will represent them on the job. In practice, this analogy is often misleading. Campaign practices in union representation elections, for example, are regulated more strictly than Common Cause could dare to dream. Judges have even been known to punish one side for making unfair promises by not only nullifying but reversing the results of an election.

One point of similarity between political elections and unionization elections, however, is that whoever gets to draw the election boundaries has a great deal of influence over the outcome. The union presence at a hospital will be very different depending on whether an "appropriate bargaining unit" consists of the entire staff, or just the nurses, or just the nurses on the night shift in the emergency room.

Neither management nor labor in these disputes is consistently in favor of making bargaining units larger or smaller. Where bargaining units are large a union may find it harder to get a foothold, but secure more power once it does. Where workers at a company are split into many small bargaining units organized by different unions, the employer may be

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able to divide and conquer or contain discontent, or may simply be exposed to "leapfrogging" tactics in negotiation and more frequent crippling strikes. When the boundaries of "appropriate bargaining units" are initially determined, therefore, there is a prime opportunity for gerrymandering to benefit one side or the other. The National Labor Relations Board gets to make the decisions on the scope of bargaining units, which is one of the many reasons why that agency is a much-fought-over political battleground.

The latest controversy over the scope of bargaining units has broken out in the construction industry, which is governed by a distinctive set of federal labor laws even more impenetrable than those that govern the rest of the economy. Under a line of cases dating from 1973, the NLRB allows unionized construction firms to set up non-union subsidiaries as separate bargaining units so long as the two businesses are independently administered and do not share individual managers. This practice of "double-breasting" allows a company to participate in both sectors of the construction industry: the non-union sector, which now dominates private construction in most areas, and the union sector, which still monopolizes government-paid and -inspired construction (because of the Davis-Bacon Act and similar laws) and which has held on to private construction in some cities like New York and San Francisco. The decline in union membership as a share of the work force has been especially pronounced in construction, which was 40 percent unionized in 1973 but only 25 percent unionized last year.

The Construction Industry Labor Law Amendments of 1985 (H.R. 281) is meant to overrule the NLRB and a Supreme Court decision that upheld the board's policy (*South Prairie Construction*, 1976). Under the bill, sponsored by Rep. William L. Clay (Democrat, Missouri), jointly owned subsidiaries within a geographical area would automatically be combined as an appropriate bargaining unit. Moreover, if a union contract had applied to one of the two subsidiaries, it would automatically be extended to both. The bill has passed the House Education and Labor Committee, and had more than 140 cosponsors as of August.

Union and construction industry lobbyists agree that H.R. 281 would effectively abolish double-breasting, forcing employers to choose between being all union and being all non-union. A staff report issued by the House Education and Labor Committee says the bill is meant to stop "corporate shell games, which are easily accomplished given the unique circumstances of the construction industry" and can lead to "the avoidance of collective bargaining agreements."

The building trades department of the AFL-CIO, which represents some fifteen unions, says that the NLRB's rulings have "undermined and subverted [the] Congressional intent" behind the Labor-Management Relations Act of 1959, better known as the Landrum-Griffin Act, which, they say, was meant to codify construction industry practice as it was then—a time when "double-breasting" had not yet been thought of. The legislative history of that law, however, does not provide much support for this claim. In August 1959, when the act was pending before Congress, then-Senator John Kennedy (Democrat, Massachusetts) introduced an amendment that would have protected a construction union's right to seek, among other things, subcontracting restrictions to require joint ventures and employers "under the same ownership and control" to go union. The amendment was not adopted, and the Landrum-Griffin Act passed the Senate without the Kennedy provisions. In early September, after the bill was reported out of conference, Senator Wayne Morse (Democrat, Oregon) introduced an amendment with provisions very similar to those of Senator Kennedy's. This amendment was not adopted either, and the conference bill passed without changes, 95 to 2.

The double-breasting provisions of the current bill are almost identical in intent to those of the Kennedy and Morse amendments. H.R. 281 would tend to use Davis-Bacon work as a lever to facilitate unionization of private construction jobs. But it would be a double-edged lever (if there is such a thing). Davis-Bacon work is important enough that some double-breasted contractors would undoubtedly choose to sell, close down, or accept unionization of their open-shop subsidiaries, so that some private construction assignments would move into the union camp. But other firms would choose to drop their union subsidiaries and give up Davis-Bacon work, which, after all, is still not a majority of construction work most

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Public Ownership vs. Energy Conservation: A Paradox of Utility Regulation

James Q. Wilson and Louise Richardson

GOVERNMENTS CONSTANTLY FACE the choice of whether to achieve their objectives indirectly, through the regulation of an industry, or directly, through public ownership of firms in the industry. In the case of electric power, public ownership has traditionally been invoked as a way to achieve lower prices, not only because government power producers were expected to charge lower rates than their private counterparts, but because their rates could serve as a "yardstick" by which regulators could judge the reasonableness of private utility pricing.

More recently, government's objectives have grown more complicated. Low prices are no longer the only major demand government places on utilities. Today utilities, both public and private, have come under pressure to engage in conservation, broadly defined—pressure to encourage their consumers to reduce energy use, exploit "softer" or "renewable" energy sources (such as geothermal, wind, or solar power), buy power from cogeneration sources, and thus postpone or cancel the building of large new generating plants.* How have the two kinds of utilities responded to these demands? In a study of three public and three private utilities completed in 1982, we found that privately owned utilities have done more than their public counterparts to encourage conservation and develop alternative energy sources.

This conclusion is based entirely on interviews with key management personnel of both kinds of utilities and with members of the appropriate regulatory and government bodies. There are virtually no reliable quantitative data that would bear on this issue because utilities are not required to publish in standardized form any measures of their investments in conservation and alternative energy. And such figures as do exist (for example, personnel employed in or dollars spent on conservation) are difficult to interpret: a figure may represent an investment in public relations, or in a productive program; a small investment in load management may yield a large return, whereas a large investment in wind power may yield a small one (or vice versa). Nonetheless, the differences we found in the organizational com-

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*Cogeneration refers to the production of electricity using the steam generated for other purposes, such as heating a building, to operate a turbine. Industrial cogeneration has a long history: for example, paper and pulp mills have cogenerated steam and electricity for decades.

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mitment to conservation and alternative energy development are so striking, and so readily agreed to by most of the personnel involved, that we are reasonably confident of our conclusion.

How one judges these findings depends largely on the value one attaches to conservation and the development of "soft" energy sources. Some, including many environmentalists, are convinced that building more large fossil-fueled or nuclear plants would be a costly mistake. Others, including some utility executives and economists, view the "soft path" as an intellectual fad that diverts attention from the energy shortage that will develop unless we build large new generating stations. We take no position on this controversy; our interest is in why one pattern of ownership has apparently led to such different results from the other.

Happy Days for Regulators

Early in this century, after the advent of alternating current had made it possible to transmit power economically over great distances, it was observed that the cost of serving the last customer added to a distribution system (the marginal cost) was often well below the average cost of generating and distributing power throughout the system. When marginal costs in an industry are below average costs, the producer with the lowest average cost will be the one that serves the most customers (or, in electric power terms, has the largest load). In this circumstance, a firm has an incentive to buy out its competitors or drive them out of business by underpricing them. That was just what happened in most communities, and economists along with policy makers were led to conclude that electric utilities were natural monopolies.

Some state and local governments adopted regulation as a way to keep private utilities from charging monopoly prices. Others, along with the federal government, created publicly owned utilities to supply electricity at what their proponents hoped would be lower prices. These public systems grew to assume a significant but not dominant role in the industry: they now serve about a quarter of all U.S. customers. Municipally owned utilities generate less than 4 percent of all the electric power produced in this country; of the roughly 3,000 municipal and cooperative utilities, most are small, city-owned distribution systems that buy electricity wholesale from a private utility and retail it to local customers. But there are a few large public systems that are fully integrated—that is, they both generate and distribute power. As Sam Peltzman and Robert Spann (among others) have shown, the advocates of public power were generally correct in thinking that these public systems would be able to underprice the private utilities. In large part, however, the lower prices simply reflect the fact that municipally owned utilities are tax-exempt and can raise capital cheaply through the municipal bond market.

The same economies of scale that led to the creation of public and private monopolies also made the running and the regulating of utilities fairly easy. As larger and more efficient generators were installed to meet increased demand, the cost per kilowatt hour of electricity fell. Declining costs meant declining rates, making it possible to reduce the price of electricity to the ultimate consumer as usage went up. Rarely did the larger utilities have to ask their regulatory agencies for permission to increase prices and frequently they found that they could offer to decrease them as a way of stimulating demand.

There has been considerable debate as to whether government—either as regulator of private utilities or owner of public ones—had much effect in keeping electricity prices down during this period. (George Stigler and Claire Friedland argued in a 1962 article that regulation had little effect; Louis D'Alessi, in 1974, disputed this view.) In any event, until rather recently most regulatory bodies and city councils could concentrate on what Douglas D. Anderson has called the "happy task of watching the industry become more efficient and, on occasion, of negotiating rate reductions."

The New Energy Environment

Those happy days ended in the early 1970s when two things happened: the price of oil began increasing dramatically, and utilities found that there were no longer easy opportunities for major new economies of scale. Before long private utilities began asking their regulators for rate increases. But the agencies that had been

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quick to lower rates were slow to raise them and often raised them less than was requested —leaving both consumers and the utilities unhappy. Even so, between 1970 and 1975 electric rates rose an average of 90 percent nationwide.

Aside from the oil-price and the scale-economies problems, several other factors were operating to drive up rates. The construction of some nuclear power plants was associated with huge cost overruns. Utilities were required to adopt costly new measures to reduce their smokestack emissions. Consumer groups began pressing for "lifeline" plans by which rates for small residential customers would be held down at the expense of general rates. To save fuel costs, many utilities began switching from high-priced oil to lower-priced coal, but the conversion process was itself expensive.

Suddenly the game had changed: new demand for electricity and new plants to meet that demand threatened to raise rates for existing customers instead of lowering them. One way to avert the need for such plants seemed to lie in getting utilities to encourage conservation on the part of their customers in order to reduce demand for electricity to the point where new plant construction would be unnecessary. Some regulatory boards, along with environmentalists (who had their own reasons to oppose new plants), began taking this line.

One might suppose that the investor-owned utilities would have opposed this initiative and instead favored continued growth of generating capacity. But many of these firms had themselves come to favor minimizing new plant construction and encouraging conservation. Previously, utility executives had been eager to make new capital investments (after all, the cost of the capital would increase the rate base on which state regulators calculated the allowed rate of return). But now government regulators were increasingly refusing to allow a company to recover the full cost of a canceled plant or to charge the full price of electricity from a completed one. More demand meant more plant construction, which meant more denials of cost recovery and lower earnings.

Whereas in the 1960s rising demand for electricity had been an occasion for joy in a utility board room, in the 1970s it became an occasion for gloom. Gone were the days when "Reddy Kilowatt" appeared on television urging people to buy more electricity and when slick magazine ads extolled the virtues of "living better electrically." Instead utilities tended to adopt a "capital minimization" strategy.

Whether voluntarily or through arm-twisting, it is undeniable that utilities began pursuing many new conservation practices during this period. Some managements adopted pricing policies designed to encourage conservation —including time-of-day and seasonal rates, which require customers to pay more for power during those times (for example, mid-day) and seasons (for example, summer) when demand is greatest, and interruptible rates, which provide lower rates to industrial or commercial customers that allow the utility to shut off power to certain machines at certain times of day. (The Public Utility Regulatory Policy Act of 1978 requires state public utility commissions to consider these and other regulatory standards in setting rates.) Other managements offered rate reductions or low-interest loans to customers who installed insulation, weatherstripping, and more efficient appliances. Finally, still others began experimenting with schemes to generate power from solar, wind, and geothermal sources, and some resorted to buying power from cogeneration plants. These steps were favored by many environmentalists and regulators not because of economic efficiency (usually, electricity from all these sources is more expensive than electricity from large coal-fired plants) but because of a belief that such sources were environmentally benign or naturally renewable. This argument was supplemented, in some cases, by a desire to decentralize energy production and weaken the economic and political power of the large utilities.

There are, of course, great variations among private utilities in how they have responded to the new energy environment. Some utilities are located in areas where demand is growing so rapidly that new plant construction is unavoidable. Others are able to meet increased demand in part by importing electric power from other states or nations. New England and New York, for example, are increasingly dependent on power shipped south from Canada by Hydro-Quebec. And in New Mexico large new plants are being built, not to supply New Mexicans with more power (they have plenty), but to export power to Southern California where demand is expected to outstrip

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supply. In general, however, utilities now seek to minimize their capital investments, especially in large, central power stations.

How Public and Private Utilities Responded

There is very little systematic information on public-private differences in responding to the demands of the new energy environment. One study, conducted by the Electric Power Research Institute in 1983, found that more than half of all investor-owned utilities had adopted innovative rate structures (primarily peak-load pricing), compared with only 6 percent of all publicly owned utilities. But since the study compares a few large private systems with many small municipal distribution systems, its results may be misleading.

To look at this matter more closely, we examined the three pairs of large utilities shown in Table 1. Each pair consists of a public and a private utility located in the same state and serving comparable markets. The pairs were chosen by virtually exhausting the universe of large, integrated firms serving comparable markets in the same state. At the time of our initial research (1982), the firms in each state were of roughly comparable size.** Operating statistics for the six firms as of the end of their 1983 fiscal years are shown in Table 2.

Table 1
UTILITIES SURVEYED

State	Public Utility	Private Utility
California	Los Angeles Department of Water and Power (LADWP)	Southern California Edison (SCE)
Florida	Jacksonville Electric Authority (JEA)	Tampa Electric Company (TECO)
Texas	City Public Service Board of San Antonio (CPS)	Dallas Power and Light (DP&L)

Each private utility is regulated by a state public utility commission (PUC) or other public body. Each public utility is an instrument of the municipal government, with its policy set by an appointed board subject to city council review. In all three states involved in our study, regulators and public interest groups have pressed hard for conservation in order to reduce the growing demand for electricity. In California and Florida, there have also been pressures to develop alternative energy sources to reduce reliance on expensive and undependable foreign oil (Texas is relatively self-sufficient in fuel, especially natural gas). In California, in addition, there has been substantial interest in using "soft" or renewable energy sources, such as wind and geothermal power. Our survey turned up similar patterns of public-private responses in all three states.

In California, the private Southern California Edison (SCE) has adopted an aggressive conservation and renewable energy program and is committed to generating over 2,000 megawatts from renewable sources by 1990. As of the end of 1983, it had 1,400 megawatts from such sources either in place or under construction or under contract. SCE already produces power from nine different sources (including wind, biomass, solar, and geothermal), more sources than any other utility in the world. In 1982, it had 74 employees in its research department and 500 in conservation and local management. In 1981, its conservation program saved an estimated 4.2 billion kilowatt-hours of electricity. As a result of these efforts, SCE was able to defer construction of a major coal-fired plant.

By contrast, the Los Angeles Department of Water and Power (LADWP) has been less than enthusiastic about conservation. Though it conducted a time-of-day pricing experiment and has made some efforts to conserve and to develop alternative technologies, it clearly does not expect these efforts to materially affect its load planning or fuel mix. One LADWP official told us that "conservation is counterproductive to unit costs," and another commented that the gains likely to be had from conservation would "make no difference to fuel planning." According to a key city official, LADWP was "never really committed" to the city's comprehensive energy plan and hopes "it will go away." LADWP has consistently planned to meet its growing power needs with new large plants. Although state policies have often kept LADWP from building plants, its management has accomplished the same purpose by buying into two coal-fired plants in Utah and Nevada and a nuclear plant in Arizona; it has also acquired an interest in a solar and a geothermal plant that SCE had built and put in operation.

**In January 1984, Dallas Power and Light fully merged into the much larger Texas Utilities Company, making its operations harder to compare with City Public Service of San Antonio. Our generalizations are based on 1982 data.

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The contrast between LADWP and SCE on conservation issues is much remarked by local utility observers. A city official, critical of LADWP, called it "more private than the privates." In turn an LADWP executive, contemptuous of SCE's eagerness to serve what he regards as the whims of energy planners, said: "If the PUC tells them to make electricity from widgets, then they must make electricity from widgets."

In Florida, utility executives are skeptical about renewable energy sources but very keen on keeping rates down by shifting to lower-cost fuels and encouraging conservation. The private Tampa Electric (TECO) is well positioned to address these concerns. Owing to plans made many years ago, by 1982 it was able to generate 80 percent of its power from coal that it buys on long-term contract and ships into the state using its own transportation subsidiaries. (Incidentally, it also owns a coal mine.) By 1984, coal-fired plants accounted for 95 percent of its generation capacity. TECO expects to reduce the growth in its peak kilowatt demand from 4.2 percent a year in 1982 to 2.7 percent in 1990, and to do this in spite of annual population growth of about 3 percent. Its conservation measures have enabled it to postpone construction of a new generation plant.

Jacksonville Electric Authority (JEA), unlike TECO, is heavily dependent on foreign oil: in 1981, it generated only 14 percent of its output from coal. Although JEA uses high-cost fuel, it has shown relatively little interest in conservation. Its executives seem to feel that since the utility already can generate more electricity than it can sell, conservation would simply cost it revenue. A JEA employee observed that conservation must be pursued to some degree because it is "like motherhood and apple pie," but that the pursuit is not very vigorous. Whereas TECO had at the time of our study fifty employees working in its conservation division, JEA had but twelve, only one of which was assigned to explore alternative energy sources. "It is not our role to do research," a JEA official said. "We don't experiment."

Table 2

OPERATING STATISTICS FOR SIX ELECTRIC UTILITIES, 1983

	California		Florida		Texas	
	LADWP*	SCE	JEA	TECO	CPSB	DP&L
Customers	1,231,929	3,325,308	236,580	364,668	398,683	326,948
Employees	4,931	16,292	1,500	3,148	3,100	2,477
Sales (millions of kwh)	18,913	59,893	5,927	10,527	8,293	12,323
Operating revenues (millions of dollars)	1,106	4,464	389	654	521	702
Monthly electric bills (1/1/84)						
Residential (500 kwh)	$33	$39	$38	$40	$37	$37
Commercial (6,000 kwh)	$410	$531	$444	$408	$441	$408
Industrial (120 mwh)	$7,606	$9,263	$7,939	$6,301	$6,083	$6,894

*Power division only.

Sources: *Moody's Municipal and Government Manual; Moody's Public Utility Manual;* U.S. Department of Energy, *Typical Electric Bills, January 1, 1984;* American Public Power Association, Washington, D.C.

In Texas, investor-owned utilities have energetically promoted conservation. Five years ago, Dallas Power and Light (DP&L) and two other major firms committed themselves to reduce peak load by 1,000 megawatts by this year. To DP&L, conservation makes good financial sense. Although it may cost $50 per kilowatt to reduce consumption by giving money incentives to builders and home owners who switch to energy-efficient appliances, it would cost $1,000 to $1,500 per kilowatt to build new capacity (as of the time of this study). City Public Service of San Antonio (CPS), on the other hand, has not aggressively offered money incentives for conservation, and its efforts to diversify its fuel mix have met with only limited success. The firm's conservation programs have had little effect on the growth in the demand for electricity. Indeed, a city councilman said that CPS had "no conservation goals;" another city official explained that, given its excess generating capacity, CPS feels "no great urgency" about conservation or load management.

Explaining the Response

To defenders of public ownership, it must be especially baffling that investor-owned utilities have done so much more than publicly owned ones in promoting conservation and the shift

(*Continues on page 36*)

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After Bhopal

COURTS OF

or Have Lawsuit

LIBERIA DOES it for tankers, Delaware does it for corporations, and our courts are now doing it for litigants. Not with anything so simple as a flag, of course; judges generally use less conspicuous standards. They have nonetheless been remarkably successful in holding out their courtrooms as harbors of convenience for plaintiffs from across the country and around the world. Combine this with the fact that different jurisdictions often have very different rules of liability, and defendants whose operations transcend jurisdictional boundaries are in deep trouble.

Choice-of-forum and choice-of-law rules have been described by *The New Republic*'s TRB as "among the most pointlessly arcane in the whole American legal system." Arcane, yes: these backwoods of the law are so tangled and obscure that landmark developments often pass unnoticed outside the legal profession. But not pointless. The method in the impenetrable madness has consistently been to tighten the regulatory ratchet. As a result, a single state's activist legislature or supreme court can now quietly set regulatory policy for the nation. Or perhaps, as Bhopal may soon demonstrate, for the world.

The Suit-of-the-Month Club

The Supreme Court's June 26 decision in *Phillips Petroleum* v. *Shutts* sets the stage. Phillips extracted gas from land located in eleven different states, paying royalties to some 33,000 owners of the gas leases. Some of these owners (three, to be precise) concluded that Phillips owed them interest—an average of $100 per plaintiff—on payments that had been delayed pending approval of a price change by federal authorities. They came together in Kansas, home of one of the three, which by happy circumstance apparently applies more generous interest rules than, say, Texas or Oklahoma, where much more gas is in fact produced. And they brought a class action not only on behalf of themselves but of the other 33,000 too. The absentees were notified of the lawsuit they had just joined, and in an "opt out" procedure familiar to book-of-the-month club members, were invited to send in a form if they did *not* want to subscribe. Some got around to doing just that, leaving a mere 28,000 in the class. Ninety-seven percent of the members of this plaintiff group, and ninety-nine percent of the underlying gas leases had no connection whatsoever with Kansas. The Kansas court nevertheless certified the class and, applying Kansas law, concluded that Phillips owed interest to all class members, payable at Kansas-established rates.

The U.S. Supreme Court affirmed the first half of this exercise but reversed on the second. A state, the Court unanimously ruled, is constitutionally permitted to take *jurisdiction* over nationwide class actions in its courts: Kansas's readiness to do so did not violate the "due-process" rights of either the defendant Phillips Petroleum—which did have some business contact with Kansas—or of the 28,000 plaintiffs—who got all they deserved when offered the chance to opt out of the Kansas lawsuit. But the Constitution was violated, seven members of the Court agreed, in the Kansas court's *choice of law*: rights under contracts uncon-

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CONVENIENCE Will Travel

Peter Huber

nected in any way with Kansas should not have been determined by Kansas law.

Three Joints in the Long Arm of the Law

Shutts-style litigation has much to do with national and even international regulatory policy. State legislatures and judges are of course active regulators in areas involving health, environmental, and safety matters, and economic relations of all description. In many instances —especially in the handful of states that have been driving their tort law toward the frontiers of absolute liability for any and all harm— local regulatory demands are not the least bit like those in other states. But no matter. The California legislature or supreme court may, for example, declare that under its law persons injured by knives may recover because the manufacturer failed to warn that knives are sharp. Even if lawmakers in, say, Texas consider the warning unnecessary.

But Texas knife victims—if they have minimally competent lawyers—will soon yearn to graze in California's greener regulatory pastures. As Justice William Rehnquist indulgently noted in another recent jurisdictional decision, *Hustler* v. *Keeton* (1984), it is "the litigation strategy of countless plaintiffs [to] seek a forum with favorable substantive or procedural rules or sympathetic local populations." A receptive California judge with dreams of improving knife-warning policies across the nation needs three tools to welcome those "countless plaintiffs" to California courtrooms:

- first, jurisdiction over all the parties—a right in the *California* courts to reach *these* particular litigants;
- second, a favorable choice-of-law rule—a right to apply California (and not Texas) law to the dispute, since California law is the only law that the California lawmakers have the power to shape; and
- third, a receptive recognition-of-judgment rule—an assurance that the California judgment will be enforceable in Texas, where the defendant may keep its assets.

Under current constitutional doctrine all three tools are readily at hand. Jurisdiction over plaintiffs presents the least of problems. It has long been the rule that the peripatetic plaintiff may go wherever he pleases; *Shutts* now establishes that he may also be *taken* wherever his self-appointed class-action lawyer pleases, so long as he does not actively protest. Of course, when the stake (for the individual class member) is trivial, few will bother to opt out, just as few would bother to opt *in* to the litigation if the choice were framed in those terms. The result: regulation through class actions in the courts, like the cookie on the ice-cream sundae, will be something few much want but few will bother to avoid.

As a result, a single state's activist legislature or supreme court can now quietly set regulatory policy for the nation. Or perhaps . . . for the world.

A court's power to reach distant *defendants* is more limited, but quite a bit less so than one might expect. *Shutts* noted that the due-process clause of the Constitution "protect[s] a defendant from the travail of defending in a

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distant forum, unless the defendant's contacts with the forum make it just to force him to defend there." One cannot briefly convey all the rich legal complexities that this simple statement conceals; to note just one, "specific" jurisdiction for an attack on a defendant's more local peccadilloes can be based on fewer contacts than "general" jurisdiction for an action against all the defendant's sins wherever committed. But in either instance, finding jurisdictional "contacts" turns out in practice to be a very creative and elastic exercise. In the *Hustler* case, for example, Kathy Keeton was permitted to sue Hustler for libel in New Hampshire because Hustler sold some of its magazines—though only a tiny fraction of its total national circulation—in that state. A defendant who lives in a state, or sells a product likely to end up there, or enters a contract, employs an agent, maintains an office, deals with suppliers, or perhaps even buys insurance there, can most probably be summoned into court there too. Specific jurisdiction is almost certainly available for a suit in connection with the specific product, contract, office, or other "contact" with that state; general jurisdiction may require a contact or two more. A defendant is wholly immune from the jurisdiction of a distant state's courts only if its contacts with the state can be characterized as "random," "isolated," "fortuitous," or entirely nonexistent. Few large corporations can meet those standards anywhere, which means that most can be sued everywhere.

The back end of the reach-out-and-put-the-touch-on-someone picture is even more favorable for the activist state judge or legislature. A little known clause of the Constitution—aptly named the "lawyer's clause"—directs that "Full Faith and Credit shall be given in each State to the Public Acts . . . and judicial Proceedings of every other State." Texas courts, in other words, must enforce a California judgment against Widget Co., even if Widget is a Texas company being sued by Texas plaintiffs and has done nothing wrong under Texas law.

The courts take this recognition-of-judgment requirement of the full faith and credit clause very seriously. A Texas court must give effect to a California judgment even if the court believes that California lacked jurisdiction over the defendant, or that the judgment was based on a California statute that was unconstitutional or on an unconstitutional application of California law to the dispute. Indeed, Texas must enforce the judgment even if the California court purported to apply—but in the view of the Texas court actually misapplied—*Texas* law in deciding the case for the plaintiff. The only judgment that the Texas court need *not* enforce is a default judgment entered after Widget boldly refuses to acknowledge or contest the California litigation. Only well-insured lawyers will be willing to take such a large and simple gamble on the small and complex jurisdictional technicality.

So everything comes down to choice-of-law rules. If a California court can open its doors to any plaintiff, reach virtually any national corporate defendant, and count on having its judgment enforced against the defendant's assets anywhere in the country, California can make tort law for the nation. Unless the California court is required, in appropriate circumstances, to apply Texas law rather than its own.

Choice-of-Law Limits

Shutts quietly staked federalism on the strength of this middle, choice-of-law joint in the judicial arm. Individual state autonomy will not be undermined (the argument must run) if California judges are not altogether free to apply California law to the dispute. It may seem bizarre that a California court should be permitted to reach across the country to snare a Texas-based defendant and then be forced to apply Texas law in deciding the case; one might suppose that courts apply only their own law to their own lawsuits. But this is not how things work. "We do not think that . . . choice of law concerns should complicate or distort the jurisdictional inquiry," wrote Justice Rehnquist in the *Hustler* decision.

Regrettably for federalism, constitutional limits on choice of law are (under current doctrine) as elastic and unprincipled as any one may find in the arsenal of regulatory activism. Here again, opaque legal principles have crystalline, real-world consequences.

To start with, a court is always free to apply its own rules of "procedure"—a term that embraces some very crucial regulatory tools. The availability of class actions, for example,

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is a question of procedure that determines whether many lawsuits will ever be initiated. Without class actions it seems doubtful that 180,000 plaintiffs (much less their inspired lawyer) would have bothered to sue Gillette Co., as they recently did, for failing to make good on an advertised offer for a free cigarette lighter worth just a few dollars.* And New Hampshire views its (unusually long) statute of limitations as procedural, a convenient fact for Kathy Keeton who resolved to sue *Hustler* only after her right to do so had expired in every other state. The icing on the cake for Keeton was that New Hampshire courts also apply the single-publication rule, which allows a libel plaintiff to consolidate all damages from nationwide publication into a single recovery. So Keeton was able to sue for her New York injuries, even though she would not have been permitted to do so under New York law or in a New York court. Such is the beauty of legal "procedure."

Elastic though it is, procedure of course does not cover everything. A California court that wishes to impose its particularly strict standards of liability on a Texas manufacturer of consumer products is not entirely free to do so. Once again, the full-faith-and-credit clause is the source of federal constitutional limits. We have already seen that the clause is a veritable tiger when it comes to enforcing a final California judgment against the defendant's Texas property. But, it turns out, the same clause starts life as a surprisingly toothless kitten when the issue is California's right to apply its own (rather than Texas) law in reaching that same judgment.

In *Allstate Insurance Co.* v. *Hague* (1981), a plurality of the Supreme Court provided yet another count-the-contacts test for what "full faith and credit" requires in choice-of-law matters. "For a State's substantive law to be selected in a constitutionally permissible manner," the plurality explained, "that State must have a significant contact or significant aggregation of contacts, creating state interests, such that choice of its law is neither arbitrary or unfair." This, however, is verbal mush that establishes no real limit at all.

The plaintiff's *or* defendant's residence *or* employment in California is almost certainly sufficient to permit California to apply its own law to the dispute, without more. When insurance companies are involved, *their* residence or business in California will also count in the "contact" arithmetic. So will almost any link between California's territory and the "transaction" involved in the lawsuit—where the contract was made, where the accident occurred, where the product was designed, manufactured, sold, advertised, or what have you. Even California contacts (a change in plaintiff's residence, for example) that conveniently arise *after* the event being litigated count as contacts in some courts, though apparently only as "little" ones. None of this much troubled the plurality in *Allstate*: the opinion blandly acknowledged that a particular set of facts could justify the application of more than one state's laws to a single dispute.

The Widening Circle

Jurisdictional and choice-of-law issues do not stop at national boundaries. We do not stand entirely alone, of course, in our willingness to reach distant defendants or in favoring the application of local rules to decide disputes regardless of their origin. Many other countries apply similar rules, in an understandable effort to take care of their own according to standards they themselves have established. But the open-door judicial policies of courts of convenience greatly amplify underlying regulatory standards, and the regulatory standards set by at least some of our states are uniquely strict.

. . . the regulatory standards set by at least some of our states are uniquely strict. . . . So strict, in fact, that most foreign lawyers view them with amazement if not incredulity.

So strict, in fact, that most foreign lawyers view them with amazement if not incredulity. This does not, however, deter their plaintiff clients from recognizing a good legal deal when

*Gillette did distribute 270,000 lighters as promised, but was caught short by an unexpectedly large response to its offer. The class action on behalf of all 180,000 plaintiffs, who hailed from all fifty states and Canada, was brought in Illinois state court. Only 12,000 of the plaintiffs were from Illinois.

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they see it. The results often verge on the Kafkaesque.

- In *Taca International Airlines, S.A.* v. *Rolls Royce of England, Ltd.*, an El Salvador corporation was able to come to a New York court to sue Rolls Royce, an English company, for damage resulting from an airplane crash in Nicaragua. Rolls Royce had no officers in New York and was not authorized to do business there. But it did own all the stock of a Canadian company, which in turn owned all the stock of a U.S. subsidiary incorporated in Delaware, which in turn had an authorized business office in New York. That connection with New York proved enough for Taca to reach the parent in a lawsuit brought in New York courts: Taca successfully argued that the grand-daughter subsidiary corporation was a "mere department" of Rolls Royce, not a "really independent entity."
- In 1980 Paraguayan Joel Filartiga was able to bring a federal court tort action against another Paraguayan, America Pena-Irala, for the torture of Filartiga's son, Joelito, in Paraguay. Joel Filartiga subsequently obtained political asylum in the United States and Pena-Irala moved here two years later. That, the Second Circuit Court of Appeals ruled, was enough to bring the matter and the parties under the statutory jurisdiction of the federal courts.
- In its 1981 decision in *Piper Aircraft* v. *Reyno*, the Supreme Court finally drew a small line, at least as to federal courts. Scottish relatives of Scottish citizens killed in a Scotland crash of a plane registered in Scotland, in circumstances already investigated by British authorities, simply could not sue the Pennsylvania and Ohio manufacturers of the plane in U.S. courts. Unfortunately, the *Piper* decision was a pure exercise of discretion; had the trial judge called things the other way, he might well have been permitted to do so.

Against this background, the ongoing legal posturing over the Bhopal tragedy leaves one with a strong case of déjà vu. The Bhopal plant was owned and operated by Union Carbide (India), an Indian corporation that is locally run by Indian management and 49.1 percent owned by Indian interests. But the other 50.9 percent was of course owned by Union Carbide (America). A legal system adept at fitting distant pegs into local holes can (if it feels so inclined) take care of the rest.

Jurisdiction over the government of India is not a problem: India is the plaintiff, it is willing to travel, and its right to do so is now almost unshakably entrenched in U.S. law. Jurisdiction over Union Carbide (America) is also constitutionally unassailable under the standard analysis: there are plenty of "contacts" between the U.S. company and the New York federal court to satisfy the plastic requirements of due process.

Whose law will be applied to the dispute? That already complicated question is further muddied by the fact that the litigation is in federal, not state court, and involves an international rather than an interstate choice of law. At the international level, the full-faith-and-credit constraint on choice of law is replaced by even more amorphous considerations of international comity. But since India itself is the plaintiff here, U.S. courts need not worry about offending Indian sovereignty by applying U.S. law to the dispute. Beyond that, the usual, almost standardless counting of "contacts" will govern.

India has already laid its list on the table. The first count of India's complaint alleges "multinational enterprise liability" (a basis for liability previously unknown to the law) and points to a series of allegedly key contacts between the accident and this country: the training of personnel, the "supervision" of the Bhopal operations, and the design, construction, and overall management of the Bhopal facility. For its part, Union Carbide can note that the methyl isocyanate was manufactured at a plant in India as opposed to the United States at the express request of the Indian government, that the plant's management and personnel are Indian and its owner an Indian corporation, and that a more than nominal portion of that corporation's shares is held by India itself. To be sure, Union Carbide owns a bare majority of the shares. But a minority shareholder that is the government (and thus controls the machinery of zoning, environmental and safety regulation, condemnation, and import controls) is no ordinary minority shareholder.

The one hope for getting the Bhopal litigation back to India, where it so obviously belongs, is the doctrine of *forum non conveniens*, which permits federal courts simply to decline to exercise jurisdiction over disputes that sensibly belong in other courts. A federal trial judge

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may make a purely discretionary call about which forum is the most "convenient," considering both the public and the private interests in having the litigation proceed in one or another courtroom. This inquiry is not an even-handed one; the plaintiff's choice of forum must be honored unless the defendant's preference is deemed vastly more convenient. Moreover, the whole exercise evokes the most disingenuous lawyerly behavior. The plaintiff—who has often traveled a great distance in search of the forum with favorable legal rules—must baldly insist that the forum is perfectly convenient, while the defendant—which is often litigating in its own backyard—must swear high and low that it would find it vastly easier to travel halfway around the world.

The Price of Promiscuity

One can understand and respect a state's desire to set regulatory standards for its own by its own, whether through its legislature or its common law courts. One can also understand the judicial urge to keep the house doors open to all customers, for without customers there is no business and thus no opportunity for judges to make the world at large a better place. But the combined effects can be very pernicious.

Regulatory Dumping. The first effect might be called regulatory dumping. India (let us say) welcomes the development of technological or commercial exports in cooperation with U.S. firms, and of course retains exclusive control over the administrative regulatory regime within its borders. Because it urgently needs these projects, it regulates them moderately, and because it needs to train its own citizens, it insists that local personnel be heavily involved in operations. India strikes a balance between tight regulation and rapid development that may be perfectly sensible for India, though it would not be for the United States.

And, of course, that is no business of *our* Environmental Protection Agency, Occupational Safety and Health Administration, or whatever other U.S. regulatory body might intervene if the same operation were conducted here. Foreign governments have in fact protested, vehemently and (one must concede) very cogently, that U.S. agencies have no business invoking U.S. securities or antitrust laws to meddle in the affairs of foreign corporations merely because they are subsidiaries of U.S. firms, and this argument would be at least equally good if U.S. safety and environmental laws were at issue. Except perhaps in matters involving the relations between corporate management and shareholders, the argument in *this* setting has almost uniformly been that a foreign firm should be governed by the law where it is incorporated or where its operations are conducted, no matter where its shareholders may live.

But when the foreign regulatory "subsidy" goes sour, as it is bound to do sooner or later, somewhere or other, the U.S. market—now policed by our civil courts instead of our administrative agencies—immediately becomes the new center of regulatory action. One day the foreign subsidiary's emancipation from U.S. paternalism is being fiercely protected by its host nation, and the next day (*after* the accident) the subsidiary has become a mere child, tightly tied to the apron strings of its U.S. parent. Thus, other nations can take the full benefits of regulating first according to their own lenient terms, and second according to our strict ones. The arrangement is too good to last.

One day the foreign subsidiary's emancipation . . . is being fiercely protected by its host nation, and the next day (after the accident) the subsidiary has become a mere child, tightly tied to the apron strings of its U.S. parent.

Interstate Ratcheteering. And it won't, because regulatees caught up in this shell game will soon catch on to how it is being played. Multistate or multinational businesses will come to understand that the attractiveness of a lenient local regulatory system is a mirage; reality is the standard of liability enforced by the strictest court in which the regulatee could conceivably land. Recognizing this solves one problem: states or countries will no longer be able to attract business by offering a superficially lenient regulatory climate, while at the same time relying on the benefits of strict judicial regulation elsewhere in case things end up going wrong.

(*Continues on page 39*)

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Taking Californians to the Cleaners

David L. Kirp and Eileen M. Soffer

SOME YEARS AGO, the California legislature considered a bill to prevent astrologers from practicing without a license. Presumably the point of the bill was to help the public distinguish legitimate stargazers from charlatans. After a hearing that sounded more like a cockfight than a scientific (or celestial) inquiry, the proposal was abandoned, providing a cheering bit of evidence that lawmakers are not yet intent on regulating everything under—or in this instance around—the sun.

But that happy ending is the rare exception in a state that requires more different groups of people to get licenses to do more things than any place else in the land. Fifty-two boards and commissions in the Golden State oversee the livelihoods of an estimated one-quarter of its adult population, including barbers, embalmers, appliance repair persons, and trainers of guide dogs for the blind. The licensing boards keep watch over cemeteries and auctions, check out the bona fides of horse races, and certify the skills of shorthand reporters. The landscape architects' board has even tried to create a special license for the people—all eight or so of them—who design golf courses.

Even as the idea of deregulation has come (and to some extent gone) in Washington, occupational regulation in California has managed to beget more regulation. Several years ago the Board of Cosmetology won a ruling from the state's attorney general that those who make a living by braiding others' hair have to be licensed. (The board went too far, though, when it tried to exclude those with dyslexia from the calling, on the theory that anyone who has problems reading letters straight should not be entrusted with bottles containing dangerous chemicals.) And the Board of Optometry, ever vigilant against the danger that patients might suffer heart failure from the strain of an eye exam, now demands that would-be optometrists be skilled at cardiopulmonary resuscitation.

Some of this regulatory activity makes good sense. The state's board of Medical Quality Assurance has a deserved reputation for trying to live up to its name. The Board of Home Furnishings' tests for furniture flammability and toxicity have been adopted by agencies across the country. Much of the rest of the regulatory apparatus consists of well-inten-

But the Board of Fabric Care . . .
is neither sensible nor well intentioned.
It has spent its forty years
taking consumers to the cleaners.

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tioned, if often misguided, efforts to protect consumers from the perils of the marketplace. But the Board of Fabric Care, which watches over the dry-cleaning industry, is neither sensible nor well intentioned. It has spent its forty years taking consumers to the cleaners.

CALIFORNIA IS THE ONLY STATE that still licenses its dry cleaners. The industry is hardly a natural target for regulation. There is no danger of natural monopoly, no body of arcana that eludes all but the most sophisticated, and no reason why unhappy customers cannot take their business elsewhere—while dragging the real shrink artists to small claims court. Over the years the stated rationale for the existence of the Board of Dry Cleaners (later renamed the Board of Fabric Care in an attempt to spruce up its image) has repeatedly changed. In a legislative battle over expanding the board's duties back in 1956, the industry's representatives actually argued that regulation was needed to separate the clean clothes from the dirty. "We don't want garments that have been cleaned and pressed to be mixed with the ones that are dirty," said an industry representative. "We know that those that are coming back from being cleaned and pressed have no bugs with them. But those coming in do have all kinds and in times past there has been no great effort made to keep them separated."

In 1967, the California Dry Cleaners' Association beat back the first attempt to kill the board by invoking the specter of the Mafia, although there was as little evidence of organized crime infiltration as there had been of bug infiltration a generation earlier. The best the industry could come up with was a *Saturday Evening Post* article detailing how an East Coast crime empire was allegedly run from the dry-cleaning establishment of a Mr. Patriarcha. "We don't want this kind of gangster in the dry cleaning business in California," said a spokesperson for the dry-cleaners' association. "With present law we can prevent this from happening." One year—and another failed attempt to abolish the board—later, the dry cleaners trotted out a less specific but equally improbable threat. Without licensing, they insisted, dry cleaners might turn into fronts for "dope peddling, bookmaking and all this type of thing."

What lay behind these flights of fancy was much more prosaic. From the beginning, the board's activities have been of pressing interest to the industry it regulates. Early on it tried to fix minimum prices for cleaning services. The state supreme court quashed that effort on the ground that lining the cleaners' pockets hardly furthered the board's mission of pursuing the "public health and safety." No matter: since then, the board has concentrated on restraining competition by making it harder for would-be dry cleaners to enter the field.

The major tools it uses for this purpose take the form of an elaborate system of licenses and exams. According to a Federal Trade Commission comment on the California industry (July 1985), the board has divided the industry into no less than eleven subspecialties, each with its own exam to determine which new applicants are fit to practice that trade. The available licenses are: plant operator (cleaning, spotting, and pressing), self-service plant operator cleaning and spotting (no pressing), dyeing plant operator, drapery plant operator (cleaning, spotting, and pressing), onsite operator cleaning and spotting (no pressing), spotting and pressing shop operator, press shop operator, fur cleaning operator, hat renovating operator, leather cleaning operator, and school or college instructor. To judge by the pass rates on these exams, which reportedly range as low as 40 percent, it is harder to become a dry cleaner in California than a lawyer.

To judge by the pass rates on these exams . . . it is harder to become a dry cleaner in California than a lawyer.

These examinations would hardly seem indispensable for product quality: dry cleaners probably turn out equally spiffy garments in, say, Washington, D.C., where a horde of anxious consumers demand spotlessness. Nonetheless, the difficulty of the exams has created a thriving subindustry of California dry-cleaning schools where aspirants can learn to distinguish grease from bubble gum. There are six such institutions in the state, more than any other state. And, more important, as the FTC comment asserts, the curtailment of new entry has kept prices and profits higher than they would have otherwise been.

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Consumer protection is a game that the Board of Fabric Care talks about incessantly but has never learned to play. That is hardly surprising in a board dominated by representatives of the industry that it regulates. Although

Consumer protection is a game that the Board of Fabric Care talks about incessantly but has never learned to play. That is hardly surprising in a board dominated by representatives of the industry that it regulates.

the board superintends some 17,000 dry cleaners, banishment from the trade is almost unheard of. The board handles its 150 monthly customer complaints by first trying mediation to iron them out, then sending the continuing disputes along to small claims court. Modest proposals to do more, such as publishing lists of dry cleaners who have been the targets of many complaints, have been vetoed as "unfair." Indeed, the board has been unwilling even to include a reference to small claims court in its consumer handbook.

Ever attentive to shifting public agendas, the Board of Fabric Care claims that it is developing expertise in handling the toxic wastes the industry generates. Yet in that undertaking the board's efforts are at best redundant (since there are toxic policemen galore), and at worst laughable. The board itself concedes that just a few years ago its inspectors knew so little about the area that their toxic inspections consisted of checking the license hanging on the wall, smelling the air for unusual chemicals, and calling it a day. So desperate has the board become to show some sign of consumerist activity that it is now trumpeting, as a Naderesque innovation, the fact that perusers of the yellow pages can now find it listed under "dry cleaners," instead of just "fabric care."

CALIFORNIA'S GOOD-GOVERNMENT TYPES have tried and failed for years to persuade legislators to stop conferring the powers and imprimatur of the state on what really is a trade association. In a 1967 report, the state's "Little Hoover" commission on efficiency in government pushed to get rid of the board, noting that "it offers no significant public protection." Since then governors have joined the cause: both Ronald Reagan and Jerry Brown tried without success to terminate the board, as did the speaker of the state assembly during the late 1970s. Even the Department of Consumer Affairs, which oversees the board, has called for its abolition. All to no avail. Bill after bill has been defeated by astute lobbying and well-placed political contributions. Last year, the sponsor of the fifth try in two decades to kill the board was hard pressed even to find a member to second his bill.

Steamed up by the repeated criticism, however, the board has added a new wrinkle to its activities. It has recently made itself the scourge of illegality in the fabric care industry, pursuing violations of its regulations with a prosecutorial vigor that is elsewhere reserved for armored-car robberies. The offenses include practicing cleaning without a license and failing to post a $1,000 bond to compensate customers in the event of bankruptcy. In one case, a seventy-five-year-old Orange County man who had been in the dry-cleaning business for half a century was carted off to jail and left sitting for six hours on a concrete floor because, in the belief that his place of business was about to be demolished, he had not renewed his bond. In another instance, a Los Angeles man who talked back to an investigator spent two days in jail awaiting trial for operating without a license. The same failure to secure a license landed a San Jose couple in jail overnight.

And things are going to get worse. At the behest of the Board of Fabric Care, the attorney general's office will soon be sticking unlicensed dry cleaners with fines of $2,500 a day, amounts that truly soar into General Dynamics territory. There might be a reason for punitive fines, though surely not jail, if there were proof that any of these operators had fleeced their customers. Yet there is not a shred of evidence that a single consumer has been badly treated in recent years by an unlicensed cleaner. On the other hand, there is a great deal of evidence that consumers are badly treated by the board itself. To judge by past experience, we can predict that—unless the legislature decides to take action—the board will continue to put California's bemused consumers through the wringer. ■

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System Error: How the IBM Antitrust Suit Raised Computer Prices

David Levy and Steve Welzer

On January 8, 1982, Assistant Attorney General William Baxter dropped the Justice Department's antitrust suit against the International Business Machines Corporation, declaring it to be "without merit." The suit, which was filed by the Department of Justice in 1969, had alleged that IBM was monopolizing the general-purpose mainframe computer market in violation of section 2 of the Sherman Act. In its thirteen years, the litigation produced more than 104,000 pages of transcript and consumed Department of Justice funds at a rate of $1 to $2 million a year.

Aside from the considerable legal expenses incurred by both parties, an antitrust suit of this magnitude and importance can have other social costs and benefits. One of the possible benefits is deterrence. The impending threat of antitrust penalty might discourage firms from (among other things) charging monopoly prices. However, the evidence indicates that the IBM case had the opposite effect. Although the litigation may have discouraged certain allegedly anticompetitive practices (bundling, for example), it also had the unintended consequence of raising prices.

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The Theory

How might this occur? In determining its pricing strategy, a firm considers how current prices affect future, as well as present, profits. A firm that charges a higher (quality-adjusted) price than its rivals will normally lose market share, as other firms already in the industry expand and as new firms enter. In a market like that of computers, the firm's loss of customers will be gradual. Existing customers will hesitate to switch vendors because of the substantial costs of converting software and retraining staff. New buyers may find it hard to distinguish between the prices and attributes of different computer systems. And competing firms will need time to plan and build new plants and increase promotion efforts. Nevertheless, customers *will* gradually be lost. Thus current prices affect future profitability through delayed effects on market share.

A firm's optimal pricing strategy—putting aside antitrust considerations—will depend on

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such factors as its present and expected future market share, its present and expected future costs relative to those of its rivals, and expected industry growth. Sometimes it will be in the firm's best interest to set prices so as to gain market share. But in a fast-growing market, the best pricing policy may be to accept losses in market share, because the internal costs of expanding along with the market are too great.

. . . the filing of an antitrust suit aimed at reducing a firm's market share will impel that firm to increase prices if it sees a reasonable probability of losing the suit. And, conversely, improvement in the firm's litigation prospects will cause it to adjust prices downward. . . .

The threat of antitrust action is likely to affect the target firm's pricing strategy by changing the firm's perception of how large its future market share will be allowed to be. By threatening the firm's right to achieve a future market share, an impending anti-monopolization suit reduces the firm's potential for future profits. The suit thereby encourages the firm to take short-run profits by raising its price toward the monopoly level. More specifically, the filing of an antitrust suit aimed at reducing a firm's market share will impel that firm to increase prices if it sees a reasonable probability of losing the suit. And, conversely, improvement in the firm's litigation prospects will cause it to adjust prices downward, in which case market shares will rise or at least fall less rapidly than before.

IBM's Reaction

The suit against IBM plainly threatened the firm's market share, for it sought not only to levy financial penalties against IBM but also to divide the firm into several smaller companies. (The precedent for such a breakup was established in the *Standard Oil* case of 1911 and reaffirmed in the *Alcoa* case of 1945.) IBM took this threat seriously, and with good reason: it had a prior history of losing antitrust cases. In the famous tie-in suit of 1936, it was forced to sell as well as rent machines; it lost a second suit twenty years later; and it was forced to divest its Service Bureau to Control Data Corporation in settlement of a private antitrust suit brought by the latter firm in 1968.

Faced with the threat of loss in future market share, IBM had less incentive than before to maintain its market share by aggressively competitive pricing. Far better to increase profits by raising prices and allowing market share to fall slowly toward the level sought by antitrust authorities. Since the *Alcoa* case, a large market share has been considered a key indicator of monopolization. Thus a decline in market share would weaken the case for breaking up IBM, and the associated expansion by rivals and entry of new firms would provide further evidence of competition in the computer market.

When the 1969 action against IBM began, delays of as long as twenty or thirty years were expected. In one way, this weakened the incentive effect, since it made an actual breakup a relatively remote prospect. But in a different way it added another incentive to lose market share. The longer the suit dragged on the more costly it would be for IBM, both directly in resources expended and indirectly in constraints on its behavior. Losing market share would improve the chance of bringing the ordeal to a quick end.

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The evidence indicates that IBM responded rationally to these incentives. The Justice Department began its investigation of IBM in 1967 and initiated the suit in 1969. Two studies of pricing behavior in the mainframe computer market, one by Ratchford and Ford for the years 1967 and 1971 and the other by Michaels for 1971, found that in those years IBM did indeed charge a price premium relative to other mainframe manufacturers. By 1980, IBM's prospects in the antitrust suit had vastly improved.

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Most of the private antitrust suits had been settled, none of the claims of monopolization had been established, and no damages had been assessed against IBM. And our study of mainframe prices for 1981–83 found that IBM had reversed course by that time and was discounting its (quality-adjusted) price by an average of 20 percent relative to other mainframe manufacturers. The results of the three studies are summarized in Table 1.*

We also examined evidence of actual changes in market shares in the electronic data processing (EDP) industry as a whole and in particular submarkets. Both these measures also showed a pattern of more aggressive marketing after 1979. Taking industry-wide figures first, IBM's share of the U.S. EDP revenues of the 100 largest EDP firms fell by only 2 percentage points between 1961 and 1968, from 52 percent to 50 percent; between 1968 and 1972, however, it fell 13 percentage points, from 50 percent to 37 percent (see Fisher et al., 1983). Thus, IBM's market share began to drop sharply when the Justice Department started investigating IBM in 1967. Moreover, it continued to fall through the 1970s, reaching 31 percent by 1979. Then in the four years 1980–83 it rose to about 36 percent (based on figures from the industry journal, *Datamation*).

It should be noted that this loss in market share was probably not the result of internal constraints that prevented IBM from expanding production. As Table 2 indicates, IBM's growth in size (real sales) slowed considerably during the 1968–72 period when the firm's market share was declining rapidly, but it then gained speed during the 1979–82 period when market share began to increase. Thus the data are consistent with the hypothesis that IBM was consciously reducing its rate of growth in the earlier period in an attempt to reduce market share.

Turning to the various submarkets of the EDP industry, we find a similar story. IBM's share in the market for mainframe computers declined during the 1970s as new competitors producing "plug-compatible" computers emerged. Thereafter IBM's share of mainframe computer sales rose from 69.4 percent in 1981 to 73.8 percent in 1983. The company's recovery in the fast-growing mini- and micro-computer markets has been even more dramatic. Criticized during the 1970s for its late entrance into these markets, it finally entered mini-computers in 1975 and micro-computers in 1981. IBM quickly became a leading firm in both fields.

Table 1

MAINFRAME PRICE PREMIUMS—IBM RELATIVE TO OTHER MANUFACTURERS

Study	Sample Years	Estimated Price Premium (percent)
Ratchford and Ford (1979)	1967	+30 to +40
	1971	+30 to +35
Michaels (1979)	1971	+10 to +20
Levy and Welzer (1984)	1981–83	−20

Table 2

GROWTH IN IBM'S SALES AND MARKET SHARE

Period	Compounded Annual Growth Rates	
	Real Sales	Market Share
1961–68	+15.1	−0.5
1968–72	+ 3.6	−7.8
1972–79	+ 4.7	−2.5
1979–83	+ 6.4	+3.8

Source: Fisher et al., and *Datamation*, May issues, 1980 and 1984.

In sum, the evidence indicates that by the time the antitrust suit was filed IBM had begun charging a price premium and that its share of the electronic data processing market began a noticeable decline from that point on. The decline continued during the seventies. Since 1980, by which time there were strong indications that the suit would be settled on terms favorable to IBM, the giant firm has discounted its prices and expanded its share of both the EDP market as a whole and the various submarkets. Other industry observers have also noted IBM's recent market change in pricing strategy and its aggressive introduction of new products and expansion into new markets (office systems, telecommunications, robotics, others). A consistent picture emerges: IBM raised its prices with the filing of the antitrust suit and subsequently lowered its prices as its prospects in the suit improved.

*All three studies employed a hedonic pricing model to control for quality variations, such as the processing speed and memory size of different computer models, and to compare IBM's quality-adjusted prices to those of other mainframe manufacturers. In several other respects, however, the methodologies of the studies differed. For discussion and explanation, see Levy and Welzer, 1984.

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Lessons Learned

Price increases are clearly not what anti-monopoly regulation should be all about. Yet the IBM suit had the immediate effect of inhibiting rather than promoting price competition. While the suit did advance the antitrust objective of reducing IBM's market share, it appears to have done so only temporarily. Moreover, it may have raised IBM's costs by making it harder for the firm to take advantage of scale economies (this in addition to the considerable legal expense incurred). The suit probably also had the effect of discouraging investments in projects with future payoffs, such as research and development.

Price increases are clearly not what anti-monopoly regulation should be all about. Yet the IBM suit had the immediate effect of inhibiting rather than promoting price competition.

The IBM case also holds more general lessons. The threat of an antitrust suit charging monopolization gives a target firm an incentive to exploit any ability that it has to raise its prices while it still can. The firm generally has plenty of time in which to implement a strategy of price increases. According to a 1970 paper by Richard Posner, the average litigated antitrust case lasts five-and-a-half years. Two modern monopoly cases, *El Paso Natural Gas* (1975) and *United Shoe Machinery* (1969), each lasted more than twenty years.

The threat of legislation, as well as litigation, can have unintended effects. In 1969, criticizing proposed bills that would have dissolved firms in highly concentrated industries, Posner pointed out that

> As leading sellers approached the point at which their aggregate market share would be so large as to trigger dissolution proceedings, they might decide to raise price as a means of preventing further growth and forestalling dissolution. That would aggravate the very problem, monopoly pricing, to which the proposed legislation is principally addressed.

Antitrust initiatives could affect a firm's pricing strategy even if they are not directly aimed at reducing the target firm's market share. For example, regulatory initiatives intended to reduce entry barriers by fiat or to constrain prices some time in the future could threaten to reduce the future profits of the dominant firm and so could give it an incentive to raise prices.

THE ANALYSIS AND EVIDENCE presented here suggest that antitrust enforcement policy can be worse than ineffectual. It may not only enrich lawyers, but also impoverish consumers. When a monopolization suit of dubious merit is brought against a large firm, the suit may simply encourage the firm to exploit fully whatever market power it does possess while the litigation is pending.

This suggests several broader conclusions. First, monopolization cases should be selected with great care. Second, the interim costs of a target's likely pricing response should be weighed in evaluating the net social benefits likely to accrue from the litigation. Third, suits that are not meritorious should be dismissed as promptly as possible, so as to minimize the consumer costs that the litigation itself tends to create. And finally, judges and lawyers must learn, here as in so many other areas, that justice delayed may entail social costs above and beyond the costs of justice denied. ■

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Thou Shalt Not Cut Prices!

Sales-Below-Cost Laws for Gas Stations

Robert N. Fenili and William C. Lane

IT SEEMS ONLY yesterday that the federal government was busy trying to hold prices down at the nation's gasoline stations. But the regulatory pendulum has had time to swing. Early this year, Georgia enacted a law that does the opposite—it prohibits the sale of certain petroleum products at prices *below* cost. Alabama enacted a similar law last year. Other such bills have been introduced in over a dozen states.

These new proposals apply only to gasoline, but general laws prohibiting the sale of products below cost have been on the books in many states since the 1930s. They were inspired by the same economic philosophy that nurtured the New Deal's Blue Eagle—the philosophy that above all sought to avoid "overproduction" and "ruinously" low prices. Many of these laws are still actively enforced: a pending case under the Oklahoma law, for example, has attracted the intervention of the Federal Trade Commission. Until now, however, there has been little empirical evidence on the effect of these laws in practice. Many observers have considered them unenforceable for all practical purposes, but this has been only a hunch.

To fill this gap, we used quantitative tools to analyze the effects of both general and specifically targeted sales-below-cost (SBC) laws on the retail market for gasoline. In our analysis, we asked three questions: How do these laws affect retail gasoline prices? Can we extrapolate from their effect on gasoline prices to their effect on prices in the economy as a whole? And is there any justification for enacting more of them?

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What the Laws Do

Almost universally, laws prohibiting merchants from selling goods below cost define cost as the sum of three elements: (a) the lesser of the invoice or replacement cost of the item, (b) freight costs and excise taxes, and (c) a markup to cover a proportionate part of the marketer's cost of doing business. The third item in the list, the minimum permissible markup, is the one that is most often in dispute, with plaintiffs trying to establish that a defendant's cost of doing business is high, and the defendant trying to prove that it is low.

Most laws use one or more short cuts for determining cost. Some fix a minimum percentage markup, commonly 6 percent at retail. Others provide that a cost survey of industry members by a trade association will establish a presumption about a defendant's overhead costs, even if the defendant did not participate in the survey. Both these cost-of-business presumptions can be rebutted if the defendant is able to prove that its costs justify a lower markup.

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(The plaintiff, for its part, can likewise try to prove that the defendant's costs were *higher* than the presumed level.)

Most commentators who view SBC laws as unimportant have emphasized the pro-defendant provisions of the laws. Many states require a showing that the defendant specifically intended to injure competitors or competition. Many allow only state agencies to enforce SBC laws, which is likely to lead to less active enforcement than if competing merchants, whose interest is obviously more intense than that of elected or appointed officials, are allowed to file suit as well. Finally, many states accept a "meeting competition" defense similar to that of the Robinson-Patman Act: price-cutting merchants can get off the hook by showing that their prices equaled or exceeded the prices of any competitor.

General SBC statutes are frequently supplemented with SBC legislation directed at particular commodities—liquor, baked goods, cigarettes, drugs, fresh fruit, gasoline, groceries, milk, and so forth. The laws covering specific commodities are far more varied in format than the general laws, but most of them also provide for one or more of the standard defenses.

In 1982, twenty-eight states maintained either general SBC laws that applied to gasoline sales, or SBC laws specifically targeted at gasoline. Twenty-two states and the District of Columbia had no law applying to gasoline sales, though some of these jurisdictions did target other products.

The Effect on the Gasoline Market

Did these laws raise or lower gasoline prices? We examined weekly retail prices for 1982 from forty-three Standard Metropolitan Statistical Areas (SMSAs) as compiled by the Lundberg Survey, Inc. Nineteen of these areas were located in states that did not have a sales-below-cost law, while the other twenty-four were in states that did. For each SMSA, we computed the yearly average retail prices (excluding sales and excise taxes) of regular gasoline, including both leaded and unleaded, and both self-serve and full-serve, making a total of four combinations in all. Prices proved to be higher across the board in areas having an SBC law.

We were aware of the danger that a straightforward comparison might be too simple, since factors other than SBC laws also affect retail gasoline prices. We therefore developed an econometric model that correlated retail gasoline prices in an area with a range of other factors in addition to SBC laws, including wholesale prices, household income, labor costs, climate, land values, the number of service stations in an area, and the population of automobiles. We also classified the twenty-eight state SBC laws as either "strong" or "weak," depending on such factors as whether the law had been recently and successfully enforced, whether it was specifically targeted to gasoline or applied generally to all commodities, whether it required the plaintiff to prove anticompetitive intent, and whether it could be enforced by private parties.

. . . it turned out that prices for all four combinations of gasoline grade and service category were consistently higher in states with SBC laws. . . .

These much more refined correlations yielded both predictable and surprising results. After accounting for other factors, it turned out that prices for all four combinations of gasoline grade and service category were consistently higher in states with SBC laws than in states without them. In SBC states, leaded regular averaged 0.9 cents a gallon higher at the self-serve pump and 2.67 cents a gallon higher at the full-serve pump; unleaded regular averaged 0.68 cents higher for self-serve and 2.47 cents higher for full-serve. All these results were statistically significant, but the findings were statistically stronger for leaded than for unleaded gasoline.

What is surprising is the substantially greater impact of SBC laws on full-serve than on self-serve gasoline. Full-service gas carries a much higher markup than self-service gas: the average retail full-serve markup in 1982 was 20 percent for leaded and 21 percent for unleaded, compared to 4 and 7 percent for self-serve gas. In many SBC states, a retailer that prices its goods more than 6 percent above delivered cost is presumptively safe (though a plaintiff can still try to rebut the presumption). As a result, one might assume that SBC laws would not

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much affect products whose retail markups were greater than 6 percent. But with gasoline, at least, they did.

Another surprise was our finding that prices in states with "weak" SBC laws were inflated nearly as much as prices in states with "strong" laws. Prices for unleaded self-serve gas were indeed higher in strong-law than in weak-law states, as might be expected. But we found no statistically significant price differences between weak- and strong-law states when it came to any of the other three goods/service combinations.

We estimate that in 1982 alone, the added cost to consumers of regular gasoline was more than $640 million.

While all the price effects of SBC laws are reckoned in pennies per gallon, the cumulative impact on motorists is far from trivial. We estimate that in 1982 alone, the added cost to consumers of regular gasoline was more than $640 million. Based on the volume of gasoline sold in the various states, $600 million of this cost arose in the twenty-five states with general SBC laws; the remaining $40 million is attributable to the laws specifically targeted to gasoline. These figures do not include the cost borne by consumers of premium gasoline, which we did not estimate.

When a Bark Is as Good as a Bite

What is one to make of these findings? At a minimum, SBC laws are not dead letters. One way or another, they are costing consumers a lot of money. Precisely how this happens is less clear, in view of our findings that more expensive gas is more strongly affected and that the weak laws have nearly as much impact as the strong ones.

One partial explanation for the unexpectedly large effect on higher-priced gas might involve consumer substitution. Perhaps what happens is that SBC laws drive up self-serve prices, which in turn encourage consumers to move to the full-serve pumps, resulting in higher prices for that commodity. Since less gasoline is sold at full-serve than at self-serve, a small percentage reduction in self-serve purchases could translate into a relatively large percentage increase in full-serve purchases.

But this explanation is at best incomplete. In fact, the gap between self-serve and full-serve prices is higher in SBC states than it is elsewhere. A bigger price gap should encourage potential consumers to switch from full-serve to self-serve, not vice versa. While some of the increase in full-serve prices might be a side effect of higher self-serve prices, the SBC laws must also be affecting full-serve prices directly.

The laws, after all, provide a legal justification for avoiding losses—something most businessmen find desirable. A natural desire to obey the law, along with some possibility of being sued, may be enough to induce full-service retailers to keep prices high. This effect is more likely where most retailers find such a "statesmanlike" pricing policy to be profitable over the long run and where it tends to be industry practice to establish a standard price or markup that is easy to identify and comply with—what lawyers call a "bright-line" rule. Such a practice, if engaged in by many market participants, insulates merchants both from competition and from potential SBC liability. Retailer self-restraint would affect full-serve more than self-serve prices because price is a more important element in marketing competition for self-serve gas. This psychological effect might also explain why it makes little difference whether SBC laws are strong or weak. If the mere existence of the law is the mechanism for price coordination, the vigor with which the law is enforced may not matter much.

An example we found in Idaho may be relevant here. A brief price war in that state ended after one independent gasoline marketer threatened to file legal action against a competitor under the state's SBC law. No suit was in fact brought, the mere threat having been enough to restore peace. In short, SBC laws may commonly be used to communicate about price in ways that would otherwise be illegal.

Implications for Other Products

Regular gasoline constitutes about 9 percent of all merchandise sold in retail trade. Extrapolating boldly from the gasoline market to the larger economy, we would hypothesize that general SBC laws cost consumers more than

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$6.7 billion in 1982, more than $56 for every man, woman, and child living in states that have such laws.

Extrapolating boldly . . . , we would hypothesize that general SBC laws cost consumers more than $6.7 billion in 1982, more than $56 for every man, woman, and child living in states that have such laws.

Is direct extrapolation appropriate? Not if —as has commonly been assumed—SBC laws are effective only when the retail markup on a product is relatively low. But the greater impact of the laws on full-serve prices seems to contradict that assumption. And the average markup for full-serve gasoline is about the same as that for grocery stores and some other retail merchants.

Direct extrapolation is also inappropriate if other merchants' trade associations are less vigorous and well-organized than those of gasoline retailers, and thus less capable of enforcing price discipline. But there is no evidence that gasoline marketers have brought more than their share of recent actions under SBC laws. The case now pending in Oklahoma, for example, was brought by retail druggists.

Projections based on limited research are hazardous. However, because we can find little about gasoline marketing to preclude extrapolation to other markets, we tentatively conclude that SBC laws have a substantial effect on general consumer prices.

Why Gas Stations Are Fewer

For thirty years, the main policy rationale for SBC laws has been that they prevent "predatory" pricing by large firms aimed at smaller independent competitors. Predatory pricing consists of selling below cost with the intent to drive a competitor out of business and then reap monopoly profits. A true predatory campaign can be seen as an illegal form of investment: by losing money now in order to clear the field of rivals, the would-be monopolist can secure a comfortable profit in the future.

The last stage in this progression is both important and frequently overlooked. Predatory campaigns cannot last forever; they must culminate in a period of high prices and monopoly profits in order to make sense. Companies will not throw away their money on driving current competitors out of business unless there are actual or potential barriers to entry that will keep new competitors from entering to take the place of the old. In years of research on this topic, relatively few verified examples of predation have been found, and in most of these some law or government regulation has served as the requisite barrier to entry.

SBC laws entirely neglect the question of whether today's low prices are likely to lead to future monopoly profits. Some of the laws require an intent to harm a competitor, but many do not. And none requires proof that a defendant has the ability to monopolize the market in question. As a result, the laws inhibit both anticompetitive predatory pricing and vigorous competition. While both forms of conduct may be found in the American economy, all evidence suggests that the latter is far more common than the former and far more commonly suppressed by such laws. SBC laws do not, on balance, make sense as a curb on predation.

The laws seem particularly inappropriate in the field where they are currently attracting much support, the retail market for gasoline. Two massive studies of gasoline marketing by the U.S. Department of Energy—we participated in one of them—found no evidence that there is widespread predatory pricing in the retail gasoline market. (See *The State of Competition in Gasoline Marketing*, 1981, and *Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers*, 1984.) Instead the studies found that consumers are the prime beneficiaries when retailers compete vigorously.

Gasoline retailers and wholesalers have persisted, however, in accusing refiners of anticompetitive practices. As evidence, they cite the dramatic decline in the number of independent gasoline dealers over the past fifteen years.* The

*Their chosen remedies include not only SBC laws but also other protective legislation at both federal and state levels, including laws restricting a refiner's right to terminate a franchisee, prohibiting refiners from operating their own retail outlets, and restricting the price at which refiners can sell to various classes of trade. For more details, see "A Dubious Bill of Divorcement: The Case of Oil Refiners and Gas Stations," by John Barron and John Umbeck, *Regulation*, January/February 1983.

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Department of Energy studies cast doubt on the accusation. They found that the decline in the number of dealers has been brought about primarily by an ordinary change in the market: because of several factors, it has become more costly to operate large numbers of low-volume, full-service outlets. One of these factors, the studies hypothesized, was the rapidly increasing cost of roadside land suitable for stations. Our current research provides quantitative support for this interpretation. As land costs (represented by appraised housing values) increase in an area, the number of retail gas stations per capita decreases sharply. In common-sense terms, as corner plots become more valuable, it becomes less profitable to maintain low-volume gas stations there. Twenty years ago, three or even four corners at a suburban crossroads could have been occupied by gasoline dealerships; now one corner will be occupied by a Wendy's or a McDonald's and another by a branch bank. But that is how the market is supposed to operate, and there is no reason to try to arrest the process by law.

Another normal market factor, the growth of self-service marketing, may also have contributed to the decline in service station numbers. Self-service gasoline has risen from about 2 percent of retail gas sales in 1969 to about 75 percent today. The average volume of a self-serve outlet is much greater than the volume of a full-serve outlet, which further reduces the number of stations needed to meet the gasoline demand. The popularity of self-serve gas is, once again, a reflection of normal market forces. Consumers prefer it, our research clearly shows, because it is cheaper, and it is cheaper largely because of its lower labor costs. Minimum wage employees are the largest single item on a full-serve retailer's list of operating expenses, and both the scope of coverage and the real level of the minimum wage has increased markedly over the past fifteen years.

IN GASOLINE MARKETING, as in other retail sectors, there is little evidence that sales-below-cost laws represent a needed response to market imperfections. They may offer some temporary protection for high-cost retailers, but they cannot reverse the changing economics of the marketplace. And for consumers—who also deserve consideration—they offer little but higher prices and market stagnation. ■

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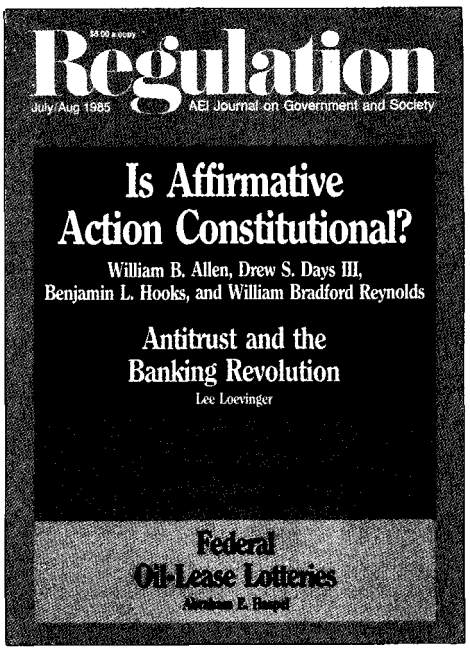
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Public Ownership vs. Energy Conservation
James Q. Wilson and Louise Richardson
(*Continued from page 17*)

to lower-cost fuels. After all, presumably firms that are governed by political authorities would be more open to such popular concerns as energy conservation. But the presumption seems wrong. Public ownership appears, if anything, to insulate utility managements from such political pressures.

To defenders of public ownership, it must be especially baffling that investor-owned utilities have done so much more than publicly owned ones in promoting conservation and the shift to lower-cost fuels.

One reason for the difference lies in the changing nature of private utility regulation, as state public utility commissions have grown in technical competence and political assertiveness. At one time, many of the PUC seats were sinecures for undistinguished political appointees who looked forward to growing old gracefully in jobs that made few demands on their time. But, as energy costs became hot political issues, governors began appointing ambitious activists to the commissions and they, in turn, began selecting staff and organizing hearings in ways that placed requests for rate increases and new plant authorizations under close and critical scrutiny. Rate increases were often approved only on condition that the firm take strong conservation steps.

Even where private utilities were allowed to recover their cost of construction, they often could not do so until after the plant was in use, and the rate of return on equity allowed by regulatory agencies was often below the market interest rate. Borrowing to build new plants made little sense under these circumstances. And issuing new stock to raise capital was equally unattractive: with the market value of the company's outstanding equity often below its book value, new stock issues would simply dilute earnings. The alternative was to delay or cancel new plants and instead offer incentives to customers who practiced conservation.

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The high cost of capital and the uncertainties of the regulatory environment have changed the extent to which private regulated utilities are subject to what economists call the Averch-Johnson effect (described in a 1962 article by Harvey Averch and Leland Johnson). Averch and Johnson observed that such utilities tend to overinvest in capital, largely because new plant and equipment become part of the rate base of the utility on which it is allowed to earn a certain rate of return. Clearly, the bigger the rate base, the greater the earnings for a given rate of return. To the extent the Averch-Johnson effect operates, the utilities will spend too much on power capacity, and the price of electricity to the consumer will be higher than it need be. Today, however, the Averch-Johnson effect has been reversed—that is, private utility executives may now have an incentive to *under*-invest in new plants.

Neither the market nor the regulators place the same sort of constraints on municipal utilities that they place on investor-owned utilities. A municipal utility can finance new plant construction through tax-exempt bonds carrying much lower interest rates than the investor-owned utilities have to pay. The prices at which they sell electricity are regulated not by PUC professionals but by lay boards or city councils that have virtually no staff at all. An LADWP official told our interviewer that his organization is subject to "very little public . . . scrutiny —we educate the board."

Neither the market nor the regulators place the same sort of constraints on municipal utilities that they place on investor-owned utilities.

Moreover, the municipality itself often has little incentive to encourage its utility to conserve. Each municipal utility pays a percentage of its gross revenues to the city treasury. For example, LADWP paid $55.3 million to the city of Los Angeles in fiscal year 1983–84, CPS paid an estimated $73 million to San Antonio in 1983, and JEA paid $25.9 million to Jacksonville in 1982. A city council is likely to be quite sensitive to rate increase proposals from the municipal utility, but quite indifferent to other actions by the utility as long as its cash contributions to the city treasury continue. Conservation by customers could conceivably endanger this revenue flow.

The legal constraints operating on government agencies also affect how the municipal utility will behave. Usually, it cannot form subsidiaries or enter unrelated businesses; hence, it cannot explore for oil, own coal mines, or run a transportation system to bring fuel to its generators. Its employees are hired, paid, and promoted in accordance with a civil service system that inhibits, if it does not prevent altogether, giving large financial rewards to employees who excel. (At LADWP, the top five posts are exempt from civil service rules.) By contrast, at DP&L, according to one of its officers, conservation goals are riveted into the organization "with a hammer." Although many municipal utilities, such as LADWP, have compiled outstanding engineering records, they cannot compete effectively for the ablest and most ambitious utility managers or reward significantly those managers who are most ingenious in devising conservation and load management techniques.

Finally, the municipal utility tends to be more insulated from political demands because few of its employees have a stake in coping with such matters. The regulated private utility, on the other hand, employs a small army of lawyers and economists to deal with its regulators and another army of financial specialists to deal with the capital market. In addition, the private utility must cultivate public opinion to foster a sympathetic regulatory environment, so it often retains specialists in opinion polling and public relations. These professionals not only represent the firm to the outside world, but represent that world to the firm. A municipal utility need employ far fewer lawyers, economists, and public relations specialists, since it does not have to deal with a state regulatory agency, and many fewer financial specialists, since it is in contact with only a small slice of the capital market. The municipal utility is owned by the city, and that ownership, its managers believe, exhausts its obligations to the political environment. Even if it should wish to cultivate public opinion or lobby elected officials, its status as a city agency would preclude it from spending much money on such efforts.

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The paradox of public ownership is that such ownership tends to insulate the firm from its political environment rather than inject that environment into the firm's internal decision processes. Marc J. Roberts and Jeremy S. Bluhm make a similar point in their account of how public and private utilities cope with environmental issues. They found the Tennessee Valley Authority and LADWP to be far less open to the concerns of environmentalists than Pacific Gas and Electric or the Southern Company. In some instances TVA simply ignored state air pollution regulations. In another case LADWP began constructing a new power plant without first obtaining the necessary permit. "Private companies," the authors concluded, "may sometimes be more responsive to public demands than government-owned utilities." They found only one conspicuous exception: Ontario Hydro, a publicly owned Canadian utility, took more initiatives to meet environmental concerns than did either TVA or LADWP.

The paradox of public ownership is that such ownership tends to insulate the firm from its political environment rather than inject that environment into the firm's . . . decision processes.

The greater resistance of municipal utilities to pressures for energy conservation, environmental protection, and the development of alternative energy may or may not be a bad thing. People who ardently support those policies often deplore the record of municipal utilities. But a critic of the policies may well conclude that political insulation enjoyed by municipal utilities has protected them from the fads and fancies that seemed to have seized state public utility commissions.

HOWEVER ONE EVALUATES the consequences of this insulation, its existence is but a special illustration, it would seem, of the general proposition that government can regulate private firms more easily than it can regulate other government agencies (see James Wilson and Patricia Rachal, 1977). Government bureaus maintain themselves by ensuring the support of their principal political superiors—typically, key legislators and their allies—and not by developing mechanisms for sensing and responding to the preferences of groups that are not part of their central political support system. The managers of government bureaus are rewarded not for maximizing the long-term economic well-being of the organization but rather for protecting the organization's political autonomy.

To the extent that government bureaus have greater autonomy than private firms, it becomes easier for the dominant professional group in the bureau to manage the bureau's affairs in accordance with the ethos of that profession. LADWP, like TVA, has from its earliest days been dominated by engineers, often engineers of great skill and dedication. When the task of the utility has required an engineering solution—as in building a new plant or transmission line—LADWP and TVA have often performed brilliantly. But when these utilities have been faced with a demand that would require giving authority to nonengineers, or taking into account goals other than engineering efficiency, they have succeeded in mounting substantial resistance. Those environmentalists who are hostile to capitalism have much to ponder here, for it has been the capitalists, not the government bureaucrats, who have been most responsive to environmental demands. ■

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Courts of Convenience

Peter Huber

(*Continued from page 23*)

But it also creates a second problem, more worrisome than the first. There is nothing inherently wrong in the decision of California's courts to enforce extraordinarily strict rules against—let us say—sharp knives. But Texas may have equally good reason to strike a different legal balance between consumers and producers, and only the Trial Lawyers of America will be confident that California's choice is the wiser one. Likewise, an industrialized western society may be able to afford a level of go-slow caution in dealing with (say) drugs or pesticides that would be criminally stupid if adopted by a third world country in the grip of epidemic disease and mass starvation; or a tiny nation of bankers like Switzerland may quite sensibly view securities and antitrust laws from a different perspective than we do. Because they carry different passengers, ambulances do not obey the same speed limits as cars.

Thus, many jurisdictions will sincerely want to maintain a moderate level of regulation, with no ulterior design to take advantage of foreign courts even should the occasion arise. But courts of convenience leave no room for a state-by-state and nation-by-nation search for the dose of regulation that is right for local circumstances. Potential defendants must, quite simply, anticipate, comply with, or insure against, the strictest regulation they might conceivably encounter. Open-door judicial policies lead everyone into the house of stricter regulation, because that is where plaintiffs always head. A very few jurisdictions offering strict regulation and a welcome to all litigants can thus have influence far beyond their borders.

. . . courts of convenience leave no room for a state-by-state and nation-by-nation search for the dose of regulation that is right for local circumstances.

America Pays. Being the national host to courts of convenience can also be expensive. Because the United States is the international center for courts of convenience, these courts are far more efficient in forcing U.S. firms to pay their foreign debts than in helping them to recover from their foreign debtors.

It would obviously be grossly unfair for California courts adjudicating interstate disputes always to choose the law that favored the California litigant, whether plaintiff or defendant. The Constitution may even forbid this in its declaration that "[t]he Citizens of Each State shall be entitled to all Privileges and Immunities of Citizens in the several States," though the precise import of this clause remains under debate in the legal literature. There is less debate, however, about the international picture. Foreigners can in fact take virtually all the "privileges" of litigating in U.S. courts under U.S. law, while retaining many of their "immunities" from back home when that better suits their purposes.

Both U.S. and international law, to start with, establish that a foreign *government* is generally immune from suit in U.S. courts unless it consents to be sued here. The federal Foreign Sovereign Immunities Act tries to strike some balance on this matter, by rejecting the immunity defense when a foreign government's alleged misconduct either causes injury in the United States or relates to commercial activities here. But these exceptions are quite rigidly territorial. Thus when the Soviet Union was recently sued in our courts in connection with its downing of Korean Air Lines flight 007 over the Soviet Union, it wasted no time in asserting its "sovereign immunity" from suit, and the case against it was promptly dismissed. And Union Carbide could not easily sue India in U.S. courts if India had (say) expropriated Carbide's Bhopal assets before the accident or simply regulated them out of existence. India, in contrast, stands a good chance of staying in U.S. courts and taking full advantage of our laws to recover damages from a private U.S. defendant.

In addition, all defendants in U.S. courts, public and private, also benefit from the "Act of State" doctrine, according to which courts will not question the conduct of a foreign government on its own turf in connection with any type of litigation. This broadly insulates both public and private foreign defendants from liability for damage to U.S. interests caused by a foreign government's condemnation of property, closure of its ports, and other executed public acts of that character.

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Finally, considerations of comity and international harmony greatly limit a U.S. plaintiff's ability to recover in our courts for another country's change in its tax or regulatory requirements, or promulgation of directives that conflict with U.S. antitrust, securities, or other regulatory policies. In its 1985–86 term, for example, the Supreme Court will be reviewing *Matsushita Electric Industrial Co.* v. *Zenith Radio Corp.*, a fourteen-year-old antitrust suit in which Zenith alleges that Japanese manufacturers conspired to drive American television makers out of business by dumping merchandise in the United States. The district court dismissed the case when it was advised by the government of Japan that Japanese manufacturers were merely following government policy. The governments of Australia, Canada, France, and Britain are also urging "mutual respect for each nation's sovereignty."

Viewed in isolation, the several requirements that our courts show delicate respect for the sensibilities and the acts of foreign governments make good sense. Governments can reasonably insist on dealing with governments, not with courts, and it seems unfair to hold a private party accountable for what its government may do or direct it to do, even if in many foreign countries the division between the public and private sector is considerably less clear than in the United States. But there is something wrong when jurisdictional privileges and immunities are asymmetric—that is, when they give more to foreign sovereigns and their protégés as plaintiffs than they demand of them as defendants. Nevertheless, that is precisely what the combination of our unusually strict regulatory systems and open-door judicial policies achieve.

Where's the Exit?

For those interested in rational regulatory policy, courts of convenience are a vexing problem, both domestically and internationally. Within this country, ironically enough, a relatively small handful of aggressive state courts and legislatures now present a real threat to state autonomy in general; internationally, overreaching U.S. courts pose a long-term threat to the regulatory autonomy of other countries. There is no single altogether satisfactory solution, but there are three areas in which developments are possible.

Market Responses. As long as the law stands as it does, the market will engage in self-help when it can. One exit from the interstate ratchet is to confine business contacts strictly to a single state. The present legal system therefore favors small companies over large ones and single-nation companies over multinationals. But whatever else it may be, smaller is generally not safer, cheaper, or more accountable. It is the large company that can afford comprehensive insurance, that can learn quickly from its national and international experience, and that can exploit economies of scale to offer consumer services and protections that would be unthinkable for the Mom-and-Pop operation. The third world knows this especially well; overbearing as they may sometimes be, the multinationals have proved absolutely essential to third-world development and economic growth. Mahatma Gandhi tried cottage industries for India, but it was high-tech pesticides and the Green Revolution that largely ended starvation on the subcontinent.

Containing the Damage. A second option is to try to confine eccentric regulatory demands to the jurisdictions that choose (whether through their legislatures or their courts) to adopt them. This requires abandoning the old and treasured principle of have-lawsuit-will-travel, or insisting that a state may apply its own laws only to lawsuits that are in its courts because of a solid connection between the dispute and the state. The Supreme Court has recently hinted that it may be receptive to change along these lines.

The easiest place to start might be in federal, not state, courts. In the exercise of their "diversity" jurisdiction, federal courts can displace state courts in deciding disputes involving litigants from different states. Since the Supreme Court's landmark decision in *Erie Railroad* v. *Tompkins* fifty years ago, diversity jurisdiction has provided only a neutral tribunal; state law has been applied to decide the merits of the dispute. This much is plainly consistent with the Constitution's federalist design. But *which* state's law is to be applied? Under current doctrine, the San Francisco federal district court deciding a suit between a California

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plaintiff and a Texas defendant must apply California's own choice-of-law rules to determine the answer.* Yet if California courts are intent on setting regulatory policy for the nation, they will of course also craft their own choice-of-law rules accordingly. Freeing the federal courts to decide for themselves which state's law to apply in diversity cases could strike a subtle blow against state-court overreaching. But it could also prove an administrative nightmare. The independent federal circuit courts have a habit of ignoring each other's pronouncements, and years of frequent intervention by the already overburdened Supreme Court might then prove necessary.

An alternative, perhaps more directly effective but administratively even more daunting, would be to reshape choice-of-law rules in the state courts themselves. There have been two recent (though characteristically backhanded) hints from the Supreme Court that some tightening of loose choice-of-law standards may be forthcoming. Justice Rehnquist's 1984 opinion for the Court in *Hustler* noted that "we find it unnecessary to express an opinion at this time as to whether any arguable unfairness [from New Hampshire's treatment of its long statute of limitation as "procedural"] rises to the level of a [constitutional] violation." A year later, *Shutts* (again written by Rehnquist) adopted a line on choice of law sufficiently firm to alarm Justice Stevens, who consistently favors the longer judicial reach in these matters. "I trust," wrote Stevens in dissent,

> that today's decision is no more than a momentary aberration, and that the Court's opinion will not be read as a decision to constitutionalize novel state court developments in the common law whenever a litigant 'most likely' would reach a different result.

Those on and off the Court who are interested in promoting federalism may be trusting precisely the opposite.

Parallel developments are possible in the international arena. Foreign governments (or their corporate arms) unwilling to serve as defendants in U.S. courts when invited to do so could be made equally unwelcome as plaintiffs. And if other nations insist (as they reasonably may) that foreign subsidiaries of U.S. corporations are outside the reach of U.S. antitrust, securities, affirmative action, foreign bribery, health, safety, environmental, and other regulatory policies, they could also be required to abandon theories of "multinational enterprise liability," when U.S. and foreign interests are reversed. Likewise, if the act-of-state doctrine is to be a complete shield for foreign public or private defendants, "omissions of state"—what Indian regulators chose *not* to regulate before Bhopal—might be given equal weight. If direct, before-the-fact interference by the U.S. government in a foreign citizen's or corporation's conduct would impermissibly offend the sovereignty of some other nation, then after-the-fact adjudications of disputes arising out of that conduct do not seem to belong in U.S. courts either. The Supreme Court's forthcoming review of *Zenith* may help to shed some light on what new directions, if any, it may plan to take in this general area.

... if other nations insist ... that foreign subsidiaries of U.S. corporations are outside the reach of U.S. ... regulatory policies, they could also be required to abandon theories of "multinational enterprise liability," when U.S. and foreign interests are reversed.

Fighting Back. A final option within the United States, is to cure the problem of locally idiosyncratic regulatory demands by squashing them altogether, at least in areas of commerce that generally involve national or multistate markets. The domestic choice-of-law ratchet will cease to operate if there is only one law to choose. Thus, the proposal of Senator Robert Kasten (Republican, Wisconsin) for national product liability legislation, like the proposed national program for compensating victims of vaccine-related injuries, would curb two litigation industries in which forum-shopping now runs rampant. This may explain why both initiatives have been quietly supported by an administration otherwise committed to greater state autonomy.

If we are to stop short of new national legislation, we could at least require state laws to

*This position was established in *Klaxon Co.* v. *Stentor Electric Manufacturing Co.*, 313 U.S. 487 (1941).

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defer more than they now do to federal regulatory pronouncements. This would put a quick end to a variety of recent judicial idiocies, such as *Chevron* v. *Ferebee*, in which Chevron was held liable under Maryland law for "mislabeling" a can of paraquat that was in fact labeled in exact accord with mandatory EPA requirements, or *Johnson* v. *American Cyanamid Co.*, in which an Idaho jury rejected the federal Food and Drug Administration's conclusion that the Sabin polio vaccine is to be preferred over the Salk alternative. It is important to repeat that even if most other jurisdictions may have less idiosyncratic views about herbicides or vaccines, the impact of decisions like *Chevron* and *Johnson* cannot be confined to the jurisdictions in which they are rendered, for the simple reason that plaintiffs will travel and large defendants must follow.

The idea of curing the problems of federalism with the sharp knife of nationally binding uniformity may seem less familiar and more radical than some of the other possible solutions, but in fact it has a long pedigree. In 1824 John Marshall first expounded on the negative implications of the Constitution's commerce clause. That clause, which explicitly grants the federal government the power to regulate interstate commerce, implicitly forbids the states to place unreasonable burdens on interstate activities. The Supreme Court has since relied on this to strike down a state's exorbitant or idiosyncratic taxes or administrative regulation. It is thus unconstitutional for a state to impose peculiar regulatory demands regarding mudflaps on trucks or maximum length on trains, or to levy a sales tax on an out-of-state seller who merely sends his goods to in-state buyers. There are the seeds of an idea here that could be encouraged to grow. National legislation would help; so would the simple recognition that what a state cannot constitutionally accomplish through its agencies, it should not be permitted to accomplish through its courts.

Sovereign Right and Responsibility

Regulatory diversity among states and nations is both consistent with federalism and sovereign autonomy and desirable to foster regulatory (or deregulatory) experiment and development. But if an independent and sovereign government has the privilege to do what it likes in shaping its own regulations and liability rules, it also has two corollary responsibilities. The first is to accept, for itself and its own citizens, the domestic consequences of these rules. The second is to avoid imposing its own idiosyncratic rules on defendants whose principal operations are centered elsewhere.

Courts of convenience as they presently operate undermine both of these responsibilities. On the one hand, they permit governments to evade the consequences of their own administrative regulatory decisions when things go wrong. On the other hand, they project local regulatory policies and liability rules into other jurisdictions where they do not belong. And it takes only a very small number of overreaching courts to shatter a federal or international regulatory system founded on autonomy and mutual restraint.

There is no simple, "more law" solution to the court-of-convenience problem, as the Bhopal litigation abundantly demonstrates. Two or more jurisdictions will almost invariably have at least arguable claim that each is the proper forum in which to resolve a dispute of any magnitude and complexity. Though attempts have been made, no one has yet found a statutory choice-of-law prescription that is both specific enough to constrain judges whose natural inclination is to overreach and at the same time comprehensive enough to cover the tremendous variety of interstate and international disputes that can arise. The only real cure for the problem lies in cultivating a much greater judicial sense of self-restraint. A judge honors neither himself nor the legal process when he throws open the house doors to any and all members of the international brotherhood of trial lawyers. Indeed, in another profession, conduct of this kind has been a source of ill-repute. ■

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(Continued from page 4)

tial are the same ones that create its unique political benefits. If Intelsat tries to placate U.S. deregulators by taking a competitive posture, it may both forfeit any future claim to U.S. restrictions on its potential competitors and lose political support from less developed countries where the consortium's politically dictated market vices are considered virtues. On the other hand, if Intelsat continues to adhere to its nondiscriminatory rates, broad interconnection policy, and cooperative-style organization, U.S. authorities may feel obliged to leave existing restrictions in place even while they chafe under the consequent limitations on the efficiency of separate system operations. In either case, an Intelsat that has lost the U.S. political backing that made it a unique vehicle for global sharing of space technology can hardly be considered a winner.

Intelsat's loss is not necessarily Orion's gain. The decisions of U.S. regulators may have turned Orion into a potential bride with a valid, blank marriage license and no dowry. Orion still needs foreign consent if it is to operate its separate system, and neither the FCC decision nor the senior interagency group's white paper presents any plan for how to secure that consent. The restrictions on interconnection with switched systems prevent Orion from offering to integrate its operations with existing European facilities, while the FCC's threat to revoke Orion's license should that firm agree to procurement set-asides for foreign firms prevents Orion from appealing to European industrial-policy interests. Whether European governments will be willing to permit new services that bypass their existing facilities or to permit competitive pricing of separate system services that could disrupt their existing tariffs is an open question. What is clear is that, without such permission, Orion too will have lost.

The European governments, in contrast to Intelsat and Orion, have been placed in a "no-lose" position. They are free to reduce their dependence on what they have historically perceived as U.S.-dominated Intelsat facilities while putting the political onus for Intelsat's decline on the United States. European governments, which will be negotiating with multiple U.S. licensees in a situation where there will inevitably be pressure on the U.S. authorities to make separate systems "succeed," may press for revenue-sharing, reciprocity, elimination of previous U.S. restrictions on using cable circuits disproportionately to satellites, and "voluntary" procurement concessions. At a minimum, it seems unlikely that the current scenario will give the U.S. the leverage to dissipate the traditional market power of European postal-telephone agencies by establishing truly competitive end-to-end satellite services. Thus, as Cowhey and Aronson ultimately recognize, the issue of competition in international telecommunications markets is far from resolved. There is a significant risk that a more diverse but less efficient international system will emerge and that no U.S. interest will fairly be deemed a winner.

Bert W. Rein,
Wiley & Rein

JONATHAN ARONSON and PETER COWHEY respond:

We do not see how either Orion or Intelsat have lost the political battle. Bert Rein argues that Orion and other entrants have won only a Pyrrhic victory because they have not yet had to confront the European governments. This argument was widely circulated in Washington during the debate over the Orion application and largely depends on the analogy of the opening of the North Atlantic airline market to competition, an analogy that we reviewed in our article.

As for Intelsat's future, Rein raises useful questions about the meaning of some of the terms of the FCC decision (which came out after we completed our paper). However, he shows a lawyer's predisposition to treat the precise wording of the decision as if it were the substance of the policy. We view the decision instead more as a setting out of preliminary guidelines on acceptable competitive strategies and as an implicit forecast of the foreseeable balance of commercial power.

Rein did not mention a recent congressional action of critical importance. Our article spoke of the conditions laid down by the executive branch for competition, which among other things protect Intelsat from loss of its core market for "switched" service (such as telephones). Not only did the FCC decide that any new satellite systems would have to comply with these strictures, but Congress has now buttressed them further by requiring (in the State Department's authorization) that they be met by any foreign country that is to do business with Orion. The two actions give Intelsat a strong basis to fight against U.S. regulatory decisions that might endanger its most important market.

We think the FCC recognizes that the total share of the market commanded by the new systems will ultimately not be large. There are several reasons to expect this outcome: the requirement that entry avoid "significant harm" to Intelsat (which effectively puts a loose cap on the number of new entrants), competition from new fiber optic cables, Intelsat's inevitable restructuring of its rates and services, and intense political attacks in Europe on new satellite systems. However, potential entry by competitors can be as economically beneficial as actual entry.

The test for policy makers is to make sure that the benefits of liberalized entry are not dissipated by additional handicaps on the new systems. The FCC's decision to set no limit on the number of competitors and to allow customers to share the use of privately leased satellite circuits (a move that significantly raises the number of potential lessors) is correct. While the new systems are testing the marketplace and the political milieu, it makes little sense to set prior limits on their room for experiments.

We agree that the U.S. government has not yet worked out a convincing diplomatic strategy. However, Rein's fears that Europe will emerge with a dominant bargaining position are misplaced. The FCC has already used its regulatory powers to prevent a similar problem in the area of international telex and telegram service, and its staff has produced lucid suggestions on how to do the same in this case. But we concur with Rein that the impasse between the U.S. government and Intelsat on how that consortium should reformulate its competitive program could both gravely damage Intelsat and impede efficient competition. Because the feud extends up to the offices of Intelsat's president and the U.S. Undersecretary of State responsible for Intelsat policy, it will take a very high level of political attention to work out a solution. Wouldn't this make an interesting mission for Walter Wriston, who is Secretary Shultz's personal advisor on international telecommunications policy? ■

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A Note on Bureaucracy

Ludwig von Mises

THE EFFECT OF BUREAUCRATIZATION is most apparent in its representative—the bureaucrat. In a private enterprise, the hiring of labor is not the conferring of a favor, but a business transaction from which both parties, employer and employee, benefit. The employer must endeavor to pay wages corresponding in value to the labor performed. If he does not do this, he runs the risk of seeing the worker leave his employment for that of a better-paying competitor. The employee, in order not to lose his job, must in his turn endeavor to fulfill the duties of his position well enough to be worth his wages. Since employment is not a favor, but a business transaction, the employee does not need to fear that he may be discharged if he falls into personal disfavor. For the entrepreneur who discharges, for reasons of personal bias, a useful employee who is worth his pay harms only himself and not the worker, who can find a similar position elsewhere. There is not the slightest difficulty in entrusting to the manager of each department the authority to hire and fire employees; for under the pressure of control exercised over his activities by bookkeeping and cost accounting he must see to it that his department shows as great a profit as possible, and hence he is obliged, in his own interest, to be careful to retain the best employees there. If out of spite he discharges someone whom he ought not to have discharged, if his actions are motivated by personal, and not objective, considerations, then it is he himself who must suffer the consequences.

In a bureaucratic organization things are quite different. Since the productive contribution of the individual department, and hence also of the individual employee, even when he occupies an executive position, cannot in this case be ascertained, the door is wide open to favoritism and personal bias both in appointment and remuneration. The fact that the intercession of influential persons plays a certain role in filling official positions in the civil service is not due to a peculiar baseness of character on the part of those responsible for filling these posts, but to the fact that from the very outset there is no objective criterion for determining an individual's qualification for appointment. Of course, it is the most competent who ought to be employed, but the question is: Who is the most competent? . . . [A]n element of arbitrariness is necessarily involved in comparing the qualifications of different individuals.

The Growth of Credentialism

In order to keep this within the narrowest possible limits, one seeks to set up formal conditions for appointment and promotion. Attainment to a particular position is made dependent on the fulfillment of certain educational requirements, on the passing of examinations, and on continued employment for a certain period of time in other positions; promotion is made dependent on years of previous service. Naturally, all these expedients are in no sense a substitute for the possibility of finding the best available man for every post by means of the calculation of profit and loss. It would be supererogatory to point out in particular that attendance at school, examinations, and seniority do not offer the slightest guarantee that the selection will be correct. On the contrary: this system from the very outset prevents the energetic and the competent from occupying positions in line with their powers and capabilities. Never yet has anyone of real worth risen to the top by way of a prescribed program of study and promotion in due course along the established lines. Even in Germany, which has a pious faith in her bureaucrats, the expression, "a perfect functionary," is used to connote a spineless and ineffectual person, however well intentioned.

Thus, the characteristic mark of bureaucratic management is that it lacks the guidance provided by considerations of profit and loss in judging the success of its operations in relation to the expenses incurred and is consequently

The Austrian economist Ludwig von Mises (1881-1973) was professor successively at Vienna, Geneva, and then New York University. This is an excerpt from his book Liberalism, *first published in 1927 in Germany and to be reissued in November by the Foundation for Economic Education, Irvington-on-Hudson, New York, and the Cobden Press.*

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obliged, in the effort to compensate for this deficiency, to resort to the entirely inadequate expedient of making its conduct of affairs and the hiring of its personnel subject to a set of formal prescriptions. All the evils that are commonly imputed to bureaucratic management . . . are the result of this one fundamental deficiency. . . .

A public enterprise conducted with an eye to maximizing profits can, to be sure, make use of monetary calculation as long as most business is privately owned and hence a market still exists and market prices are formed. The only hindrance to its operation and development is the fact that its managers, as functionaries of the state, do not have the personal interest in the success or failure of the business that is characteristic of the management of private enterprises. The director cannot, therefore, be given freedom to act independently in making crucial decisions.

But, in fact, it is only seldom that a public enterprise aims at nothing but profit and sets aside all other considerations. As a rule, it is demanded of a public enterprise that it keep in mind certain "national" and other considerations. It is expected, for instance, in its procurement and sales policy, to favor domestic as against foreign production. It is demanded of state railways that they set a schedule of rates that will serve a specific commercial policy on the part of the government, that they construct and maintain lines that cannot be profitably operated simply in order to promote the economic development of a certain area, and that they operate certain others for strategic or similar reasons. When such factors play a role in the conduct of a business, all control by the methods of cost accounting and the calculation of profit and loss is out of the question. The director of the state railways who presents an unfavorable balance sheet at the end of the year is in a position to say: "The railway lines under my supervision have, to be sure, operated at a loss if considered from the strictly commercial point of view of profit-seeking private enterprise; but if one takes into consideration such factors as our national economic and military policy, one must not forget that they have accomplished a great deal that does not enter into the calculation of profit and loss." Under such circumstances the calculation of profit and loss has clearly lost all value for judging the success of an enterprise, so that—even apart from other factors having the same tendency—it must necessarily be managed quite as bureaucratically as, for example, the administration of a prison or a tax bureau.

The Bureaucratization of Private Firms

No private enterprise, whatever its size, can ever become bureaucratic as long as it is entirely and solely operated on a profit basis. Firm adherence to the entrepreneurial principle of aiming at the highest profit makes it possible for even the largest concern to ascertain with complete precision the part played by every transaction and by the activity of every department in contributing to the total result. As long as enterprises look only to profit, they are proof against all the evils of bureaucratism. The bureaucratization of privately owned enterprises that we see going on about us everywhere today is purely the result of interventionism, which forces them to take into account factors that, if they were free to determine their policies for themselves, would be far from playing any role whatsoever in the conduct of their business. When a concern must pay heed to political prejudices and sensibilities of all kinds in order to avoid being continually harassed by various organs of the state, it soon finds that it is no longer in a position to base its calculations on the solid ground of profit and loss. For instance, some of the public utility enterprises in the United States, in order to avoid conflicts with public opinion and with the legislative, judicial, and administrative organs of the government which it influences, make it a policy not to hire Catholics, Jews, atheists, Darwinists, Negroes, Irishmen, Germans, Italians, and all newly arrived immigrants. In the interventionist state, every business is under the necessity of accommodating itself to the wishes of the authorities in order to avoid burdensome penalties. The result is that these and other considerations foreign to the profit-seeking principle of entrepreneurial management come to play an ever increasing role in the conduct of business, while the part played by precise calculation and cost accounting concomitantly dwindles in significance, and private enterprise begins increasingly to adopt the mode of management of public enterprises, with their elaborate apparatus of formally prescribed rules and regulations. In a word, it becomes bureaucratized.

Thus, the progressing bureaucratization of big business is by no means the result of an inexorable tendency inherent in the development of the capitalist economy. It is nothing but the necessary consequence of adopting a policy of interventionism. In the absence of government interference with their operations, even the largest firms could be run in exactly as businesslike a way as the small ones.

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Readings
of particular interest

More Economies of Scale in Regulatory Compliance

Firm Size and Regulatory Compliance Costs: The Case of LIFO Regulations by John C. Hilke (Federal Trade Commission Bureau of Economics, December 1984), 64 pp.

Most businesses use one of two accounting systems to put a value on their inventories. Under the older of the two systems, FIFO (first-in-first-out), items sold from inventory are typically valued at prices prevailing some time earlier. Consequently, when prices of inventory items are rising, firms that use FIFO report higher profits than similarly situated firms that use LIFO (last-in-first-out), a system that values inventories at approximate replacement value. Businesses often regard the extra profits reported under FIFO as an artifact of inflation rather than a sign of real prosperity; in addition, FIFO users pay higher taxes than LIFO users in periods of general inflation like the past two decades. Thus there has been a broad shift toward LIFO since it was introduced shortly after World War II.

Many firms, however, particularly small ones, have still not switched to LIFO. According to this staff report by John Hilke, an economist in the Federal Trade Commission's Bureau of Economics, federal tax regulations that govern the adoption of LIFO have helped slow down the switch. Moreover, by creating economies of scale in regulatory compliance costs, the rules have differentially handicapped small firms. To the extent that FIFO overstates profits, the result may be to distort the tax system and introduce a bias against small firms and against inventory-intensive methods of doing business, resulting in the misallocation of resources.

The main body of the report is an analysis of the response to a 1983 survey of wholesaler-distributors about LIFO regulations and costs. The survey data confirm indications from the Internal Revenue Service that many firms, particularly small firms, continue to use FIFO. According to Hilke, the survey data indicate that small firms' low rate of LIFO usage is not a result of their clustering in low-inflation and low-inventory industries where LIFO might not make much difference in tax liability.

More than half of the small firms that did not use LIFO in 1983 said that the cost of switching was a very important factor in their decision to stay with the old system. More than 40 percent of the medium to large firms also considered switching costs to be a major reason for avoiding LIFO. Among firms that already use LIFO, perceptions were different: few of them indicated that conversion costs had been much of a deterrent in their decision to switch.

That might suggest that the fears of switching are to some extent groundless and arise from a lack of information. But the data contradict that thesis. Non-LIFO users that are well informed about conversion costs are just as concerned about them as their less informed colleagues.

The FTC study finds that the pattern of conversion costs incurred by LIFO users surveyed provides a reasonable explanation for small firms' concerns about the costs of switching. Respondents reported that the costs of switching totaled more than $35,000 for the average firm and $23,000 for firms under $5 million in annual sales, a figure that is proportionately much more burdensome for these firms; it represents 30 percent of an average year's profits. In effect, the report says, the costs of complying with LIFO regulations or sticking with FIFO seem to act as a regulatory economy of scale that inflicts particular comparative disadvantage on small firms during inflationary periods. The effect seems to hold within the industry subgroups that were studied as well as for firms overall, Hilke says.

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Various regulatory changes have been suggested to lessen the burdens of switching. The most promising, in Hilke's view, is a proposal to change IRS regulations to allow firms to use government price indexes to revaluate inventory instead of calculating inflation rates based on the specific mix of items held by each firm. Such a change could provide substantial cost savings to both large and small firms: the firms surveyed estimated that it would cut their compliance costs by slightly more than half.

State Severance Taxes: Are the Dangers Exaggerated?

"Energy, Taxes and Growth" by Bernard L. Weinstein, in *Transaction: Social Science and Modern Society*, vol. 22, no. 1 (November/December 1984), pp. 41-47.

For decades many energy-producing states have levied taxes on the coal, oil, and natural gas produced within their boundaries. Texas, for instance, has taxed oil for more than seventy-five years. These "severance" taxes, as they are sometimes called, started to attract wide attention in 1979 when the federal government instituted a phased decontrol of oil and natural gas prices. As oil and gas prices began to rise, severance tax collections rose in tandem. Revenue from Texas's oil tax jumped by 200 percent from $435 million in 1978 to $1.3 billion in 1982. In 1974, state severance taxes nationwide had amounted to $1.2 billion; by 1982 they were bringing in $7.8 billion, with just four states (Texas, Alaska, Louisiana, and Oklahoma) capturing 72 percent of the total.

An unpublished but widely circulated 1979 study for the U.S. Treasury estimated that the increased state and local revenue over the 1980s resulting from oil decontrol would amount to $128 billion. The accuracy of these estimates later came into question, since oil prices could go down as well as up. But the amounts were enormous enough to evoke the spectre of substantial fiscal disparities between energy "have" and "have-not" states. Severance taxes, it was feared, would enable a few states to grow rich at the expense of consumers in other states.

A number of Northern politicians and groups began calling for reform, and bills were introduced in Congress to limit the states' power to impose severance taxes. Some went even farther and called for replacing the state taxes with a uniform federal severance tax, on the grounds that the benefit from energy deposits belongs in some sense to the nation as a whole rather than the producing states.

Any such bill would certainly come under constitutional challenge, because states have traditionally guarded their right to tax with great jealousy, writes Bernard Weinstein of the Cox School of Business at Southern Methodist University. In fact, carried to its logical extreme, the Northerners' line of reasoning would justify the federalization of far more than just energy revenues, Weinstein says. If Minnesota can lay claim to some of Texas's oil, why should not Texas lay claim to some of Minnesota's water and fish? In fact, why should states with ample rainfall not be forced to send some of it to the arid West through long-distance irrigation pipelines?

In spite of all the consternation about the severance tax, Weinstein says, little attention has been paid to its impact on the economies of energy production and consumption (as opposed to the fiscal condition of state treasuries). While federal taxes are for the most part based on the net income or profits of the producing company, state severance taxes are typically based on the value of the commodity itself. Even more than profits taxes, severance taxes directly reduce the amount that will be produced and offered for sale at a given price, discourage new investment in extractive activities and depress the long-term level of production.

In the short run, the severance tax and other state energy levies can have serious effects on industry profitability. A recent study by the General Accounting Office found that changes in state taxes significantly affected the value of operating mines to their owners and the investment potential of undeveloped deposits. Over time, however, capital and skilled labor will withdraw from states with differentially high severance tax burdens. Investors will leave the industry and employment will shrink. After these adjustments, the burden of the tax will fall in the form of property losses to owners of the least mobile resource, land. Because most of the factors of production enjoy long-run mobility, in other words, officials in energy-

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producing states will eventually find themselves harming not out-of-state corporations, but their own land-owning taxpayers. In addition, the decline in production will itself depress severance tax revenues. These factors may give states an incentive to keep their severance tax rates from getting too far out of line with those of other states.

Two other considerations also make it less likely that severance taxes will lead to a polarization of rich and poor states. First, all states have ways to tax consumers in other states, notably through the "unitary" tax by which states can reach the out-of-state profits of companies that operate in the state, including oil retailers. Second, especially in the case of coal and synthetic fuels, severance taxes may be barely enough to cover the cost to the state of extending new public services to the areas of new production.

In any case, the author says, Washington could employ market mechanisms, rather than federal preemption, to reduce the dangers of runaway severance taxes. Such an approach might include rapid and complete decontrol of all energy prices, revision of federal laws and regulations pertaining to fuel use, the revival of the nuclear power program (including the fast-breeder reactor), a modest relaxation of air quality standards so as to encourage greater use of coal and lignite as boiler fuels, and the building of coal slurry pipelines to reduce transportation costs of both eastern and western coal. These steps and others would hasten the day when all fuels were priced on an energy-equivalency basis, a policy, says Weinstein, that would make it harder for any single state to levy excessive production taxes.

Stoking Toxic Fears

Chemical Risks: Fears, Facts, and the Media, with a foreword by Patrick D. Maines, published by the Media Institute (March 1985), 71 pp.

Anyone who watched television news or read a typical newspaper over the last five to ten years could easily have come to believe that our world is made far riskier and more dangerous by the presence of synthetic chemicals all around us (and in us, thanks to the foods we eat). Many scientists and other observers have complained that the press and especially the broadcast media report the direst-sounding scientific warnings while omitting the uncertainties and qualifications with which the warnings are hedged—resulting in a sensationalized and distorted public discussion.

This study by the Washington-based Media Institute examines print and broadcast coverage of three chemical-related events that occurred between 1982 and 1984: the contamination of soil in Times Beach, Missouri, by the toxic chemical dioxin; the discovery of residues of ethylene dibromide (EDB) in some citrus fruits and grain products; and the derailment in Livingston, Louisiana, of a freight train carrying vinyl chloride and other chemicals. The centerpiece of the research project was a content analysis of 250 stories that had appeared in the *New York Times*, *Washington Post*, and *Los Angeles Times*, and on the ABC, CBS, and NBC nightly news shows.

The study suggests that these news outlets were not shy about sounding the warning alarm. Assertions that chemicals posed significant risks appeared in stories from three to seven times more often than counter-assertions that risks were low or nonexistent.

Significantly, government sources were cited more often than all other identified sources combined. In newspaper coverage of Times Beach, for example, government sources accounted for 53 percent of all sources quoted, while the next-most-quoted group consisted of "man-in-the-street" figures (17.2 percent). Industry sources accounted for less than 1 percent (0.6 percent) of Times Beach coverage, while independent experts outside industry were quoted sparingly, when not virtually ignored. These two groups combined amounted to only 2 percent of all sources quoted in the Times Beach case, 3 percent in the train wreck case, and 15 percent in the EDB case.

Not only was government quoted far more often than other sources, but nearly four-fifths (79 percent) of the statements by government sources on health risks alleged that a serious risk did exist. By contrast, the independent (nonindustry) experts who were interviewed were only half as likely as government officials to say that risks were significant.

In all three controversies scientists were actively debating whether the residents or con-

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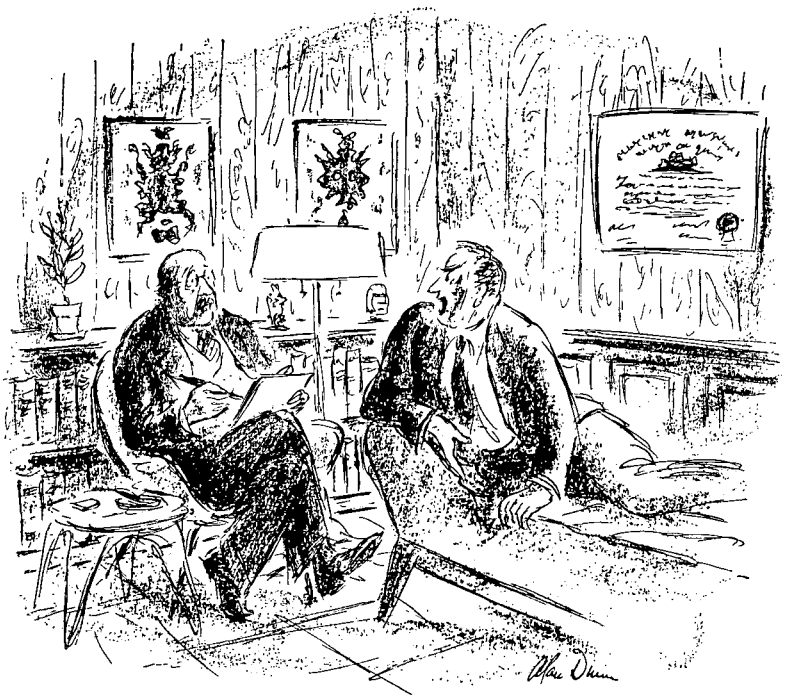
sumers in question were or were not exposed to significant risks. By focusing on government warnings and simplifying ambiguous scientific data, the report says, the media tended to foreclose each debate in favor of the conclusion that the health risks were real. President Patrick D. Maines of the Media Institute writes in his foreword that if the media had relied more on outside experts and less on government sources, the thrust of these stories and their emphasis on risk would have been markedly different. By emphasizing the warnings of government sources, the coverage effectively sided with those who took a grim view of the incidents.

Television reporting, in particular, relied heavily on "man-in-the-street" interviews with average citizens, even when cases turned on complex technological issues where expertise would seem to be called for. In all three cases, citizens were second only to government spokespersons among identifiable sources in TV coverage. Typical was this NBC quote from a citizen in the aftermath of the Louisiana train wreck: "Some of us went into our houses and there are dead bugs in the houses. If bugs can't live—we can't either." The report observes that such emotional public interviews enhance the tone of dramatic urgency that characterizes television coverage, and that scientists rarely are given a chance to analyze the resulting anecdotes or assertions either on camera or for publication. Rarely even do the journalists themselves subject the public fears to serious scrutiny.

In conjunction with the study, the institute also conducted a "Q-Sort" analysis (which is akin to a focus group analysis) involving George Washington University students. Participants agreed that TV news was more sensational in its coverage than newspaper reporting. Asked to rate the lead sentences of newspaper and TV stories for sensationalism, participants found all the outlets (except the *New York Times*) to show some degree of sensationalism, with CBS at the top of the heap. The coverage in both media of the EDB case was slightly less sensational than that of the Times Beach and Louisiana train-wreck cases.

The report concludes that the media "missed the opportunity to present the legitimate debate that was taking place among government, scientific, and industry experts" on the three incidents. Repeated warnings of impending chemical catastrophe may make good copy, the report warns, but they can inadvertently seduce viewers (and policy makers) into unconscious chemophobic choices. "It does not require an overly developed capacity for cynicism to understand that government sources (particularly at places like EPA) have their own vested interests, every bit as real and compelling as those imputed to businessmen and industrialists," Maines writes. "That so many eminent journalists spend so much time acting as little more than the conduits of government handouts is one of the greater, and lesser, ironies of their profession."

The study also includes a brief preliminary look at the first three days' coverage of the gas leak in Bhopal, India. Media outlets examined were the *New York Times, Washington Post, Wall Street Journal*, and the three networks.



"All right, I am afraid! I'm afraid to eat, to drink, to smoke, to drive, to fly, to breathe! And why shouldn't I be?"

Drawing by Alan Dunn;
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Like the three earlier chemical incidents, Bhopal tended to receive sensational coverage, but this time for a good reason: an actual disaster had taken place, killing two thousand people. Television footage was more vivid by far in portraying the drama of the event, while the strength of the print outlets was in conveying a broader range of information, devoting more space to background material and related stories, and better analyzing the long-term implications of the accident. An opinion survey of thirty-five print editors and chemical industry communications executives, reported in this section of the report, finds both groups giving the media high marks for their coverage of Bhopal, although executives found the coverage more sensational than did editors.

On Judges as Risk Managers

"Safety and the Second Best: The Hazards of Public Risk Management in the Courts" by Peter Huber, in *Columbia Law Review*, vol. 85, no. 2 (March 1985), pp. 277-337.

Much of the legal community shares a three-part consensus about the hazards of technology. First, the price we pay for new technologies and mass-produced goods is public exposure to a large and growing amount of external and nonconsensual risk. Second, public risks represent both market failures and moral wrongs. Third, the courts not only may but must provide stricter regulation. They can do this both prospectively, through injunctions and strict review of agency action, and retrospectively, by awarding damages to victimized parties in class actions for actual injury, exposure to risk, or even the apprehension of risk.

Peter Huber, a Washington, D.C., attorney, argues that more often than not, activities that create public risks represent progressive—that is, risk-*reducing*—social investments. The reason is that the incremental public risk created is usually smaller than the existing privately borne risk—often borne by the same people—that is displaced. The main sources of manmade public risks are new technologies, new chemicals, new consumer products, and new industrial processes. Though often hazardous, these advancements are on average much safer than the old hazards they displace. Central water supply systems, power plants, and pest-spraying programs are generally much safer than the private wells, wood stoves, and yard-by-yard spraying they replace. The products of mass production also create public risks, but these too are generally safer than substitute private-risk sources of goods and services. Greater overall safety thus generally calls for the greater acceptance of public risk.

This has implications, Huber says, for the economics and moral philosophy of public risk activities. In a world permeated with risk of both nature's and man's creation, it is economically inefficient to treat every unit of manmade public risk as an economic externality. Hazardous human activities impose external costs only insofar as they create more risk than they remove. A rule of the "second best" thus applies in risk markets, just as in economic ones. Moreover, a morally just law of risk, like an "efficient" risk economy, wastes no time with risk in the absolute, but focuses instead on the marginal changes in the risk environment that a given activity may produce.

Huber concedes that public risk choices inherently require some form of public control, both to protect individuals from overproduction of public risks and to prevent the underproduction of public risks that can result from individual obstruction of worthwhile measures. But the courts do not perform well in setting the public "risk budget" because they are institutionally incapable of accurately balancing risks created against risks averted, as progressive public-risk management requires. Experience demonstrates, in fact, that the courts generally make regressive risk choices. They systematically prefer old risks to new ones, and natural or "custom-built" items to mass-produced substitutes. Both of these preferences tend to make life more dangerous, not safer. Huber illustrates his argument with an account of the current crisis in vaccine liability, in which, he says, a capricious and undisciplined legal system has been brought to bear against products that plainly remove far more risk than they create.

The spheres of competence for the courts and the agencies in fact mirror the division between private and public risks, the author says. Courts can perform adequately in resolving narrowly tailored, bilateral, private hazard dis-

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putes. But risks that involve diffuse, low-probability, multilateral, and temporally remote harms should be managed by administrative agencies which, imperfect though they are, are institutionally positioned to weigh risks wholesale and balance risk reductions against risk increases. Thus the courts, Huber concludes, should give much greater deference to risk choices made by the agencies than they currently do.

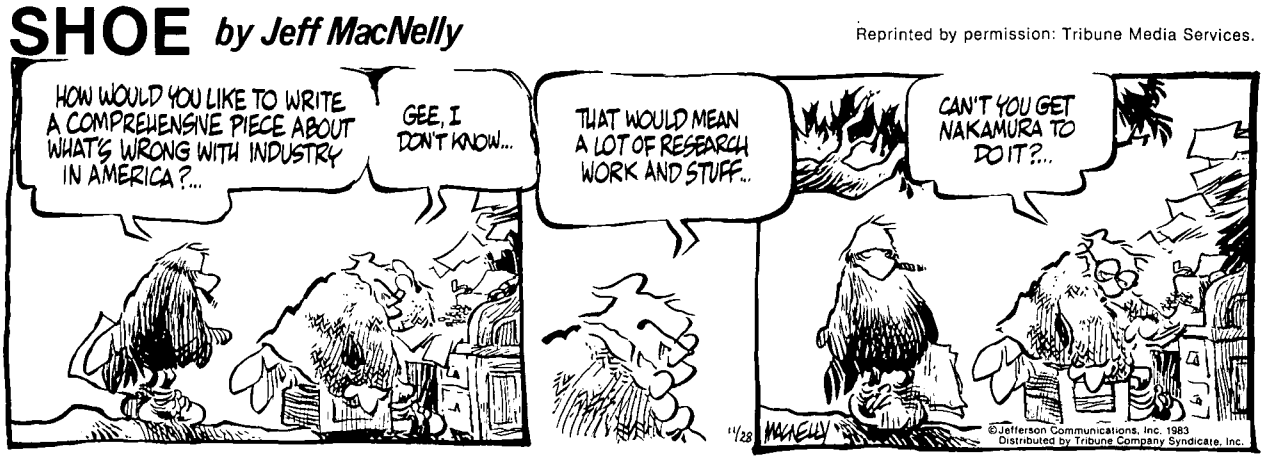
Updating the Costs of Trade Protection

Aggregate Costs to the United States of Tariffs and Quotas on Imports: General Tariff Cuts and Removal of Quotas on Automobiles, Steel, Sugar and Textiles by David G. Tarr and Morris E. Morkre (Staff Report, Bureau of Economics, Federal Trade Commission, December 1984), 148 pp.

This study is an attempt to estimate the net effect of trade barriers on the American economy in 1984. David Tarr and Morris Morkre, who are economists at the Federal Trade Commission, conclude that tariffs and quotas have been costing the United States economy at least $8.5 billion a year.

The authors used two quite different methods to gauge the effects of tariffs and of import quotas. In the case of tariffs, they employed a model of the world economy to estimate what would happen to the U.S. economy if all tariffs, both ours and those of our trading partners, were removed. In all, they found that tariffs were inflicting $6.3 billion in annual damage on the United States. It was not so easy to estimate the effects of removing quotas and other nontariff barriers. So the authors restricted themselves to analyzing four major quotas imposed by the U.S. government, using economic models of each industry. They included the quota on Japanese automobiles (which was lifted early this year), and those on sugar, steel, and nine apparel items from Hong Kong. The most important of these was the quota on autos, which cost the U.S. economy $1 billion a year (in efficiency losses and transfers to foreigners), followed by the restraints on steel ($780 million), Hong Kong apparel ($370 million), and sugar ($250 million). Since many other products are subject to U.S. quota restrictions, the resulting sum understates the costs the United States is unilaterally imposing on itself; the tariff figure, by contrast, includes not only the unilaterally imposed costs but also the costs of foreign tariffs.

When the authors calculated the present value of a continuing stream of these annual tariff and quota losses, the results were more arresting. The present value of the tariff costs over the next twenty years amounts to $72 billion. As for quotas, those on sugar and apparel could be expected to cost $2.9 billion and $4.2 billion respectively over the same period. To take a twenty-year period as a measure of future tariff and quota costs is not unrealistic: textile quotas have already lasted more than twenty-five years, while steel received some protection in eleven of the last fifteen years. Over a conservative span of four years, the sugar quotas would cost the economy $900 million, the apparel quotas $1.3 billion, and the steel quotas $2.8 billion.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Losses to consumers—as distinct from those to the economy as a whole—are much larger than this, because one of the major effects of quotas and tariffs is to transfer wealth from a country's consumers to its producers and the government. The sugar quota is the best example of this phenomenon: U.S. consumer losses would amount to $2.7 billion over four years, nearly three times more than the losses to the general economy listed above.

In addition, all four quota schemes bestow windfall benefits on the foreign producers that are awarded quotas, by assuring them a higher price for the products they are allowed to sell on the U.S. market. This transfer—a loss to the U.S. economy, but a gain to other countries—amounts to $238 million a year for sugar, $264 million for Hong Kong apparel, and $557 million for steel.

As they did in an earlier study published in 1980 (see Readings, *Regulation*, January/February 1981), Tarr and Morkre proceed to compare these losses with the possible gains afforded by trade protection, namely, the unemployment and transition costs that are averted if American industries do not close down plants under pressure from imported goods. In the case of steel, "for every dollar of earnings losses saved by otherwise displaced workers, consumers lose $34.60 and the United States economy loses $24.57." The average cost for each job saved by this restriction is $114,000 to consumers and $81,000 in efficiency losses to the economy. In the case of apparel, the authors estimated the employment *benefits* of the quotas on not only Hong Kong but also Taiwanese and South Korean apparel, though the *costs* of protection were calculated for Hong Kong alone. Even under that conservative assumption the cost per job saved amounted to at least $41,800; and since the cost of adjustment for 8,900 unemployed apparel workers is an estimated $20 million, the ratio of benefits from removing quotas to adjustment costs is at least eighteen to one. In the case of the sugar program the authors assumed that the federal government's price support system would absorb the output of sugar producers, at some expense to the Treasury; even so, the price U.S. citizens would pay as taxpayers would be considerably less than they are now paying as consumers under the quota system.

"Double-Breasting"
(*Continued from page 12*)

places. After an unsettled period, the line-up of contractors would likely emerge much as it is now, except that the roster of owners would have changed, and the firms in each area would be divided into separate union and non-union castes. If so, H.R. 281 might even accelerate the trend toward non-union construction. A spokesman for the building trades unions says that this risk is one his group is prepared to take.

The Clay bill also would enact a number of other union-sought changes in the labor laws governing construction. For example, it is currently possible for an employer who has been operating under an umbrella agreement between contractors and unions in an area to slip out from under the umbrella and operate independently on a non-union basis. Under the Clay bill, such employers would continue to be covered by the umbrella contract unless their workers specifically voted to reject it.

Several attempts to amend H.R. 281 in subcommittee were rejected in votes along party lines. Rep. Steve Bartlett (Republican, Texas) offered an amendment that would have required the holding of a secret ballot, rather than the submission of authorization cards, to secure union representation. Another losing Bartlett amendment would have required secret-ballot votes on whether to go out on strike, whether to continue a strike (with votes taken every thirty days during its duration), and whether to accept an employer's contract proposals.

A third amendment, offered by Rep. Richard Armey (Republican, Texas), would have ended the double-breasting controversy by defining each job site as a separate bargaining unit. For the unions, that would have been the worst possible outcome: it would have forced them to organize from the "bottom up" rather than from the "top down." But—to the extent that "worker democracy" makes any sense as a guiding principle—smaller bargaining units possess at least one advantage, in that they provide a closer fit between worker sentiment and representational results than larger ones. As public choice theory tells us, the larger the bounds of the electoral unit, the more people wind up being represented by a candidate they have voted against.

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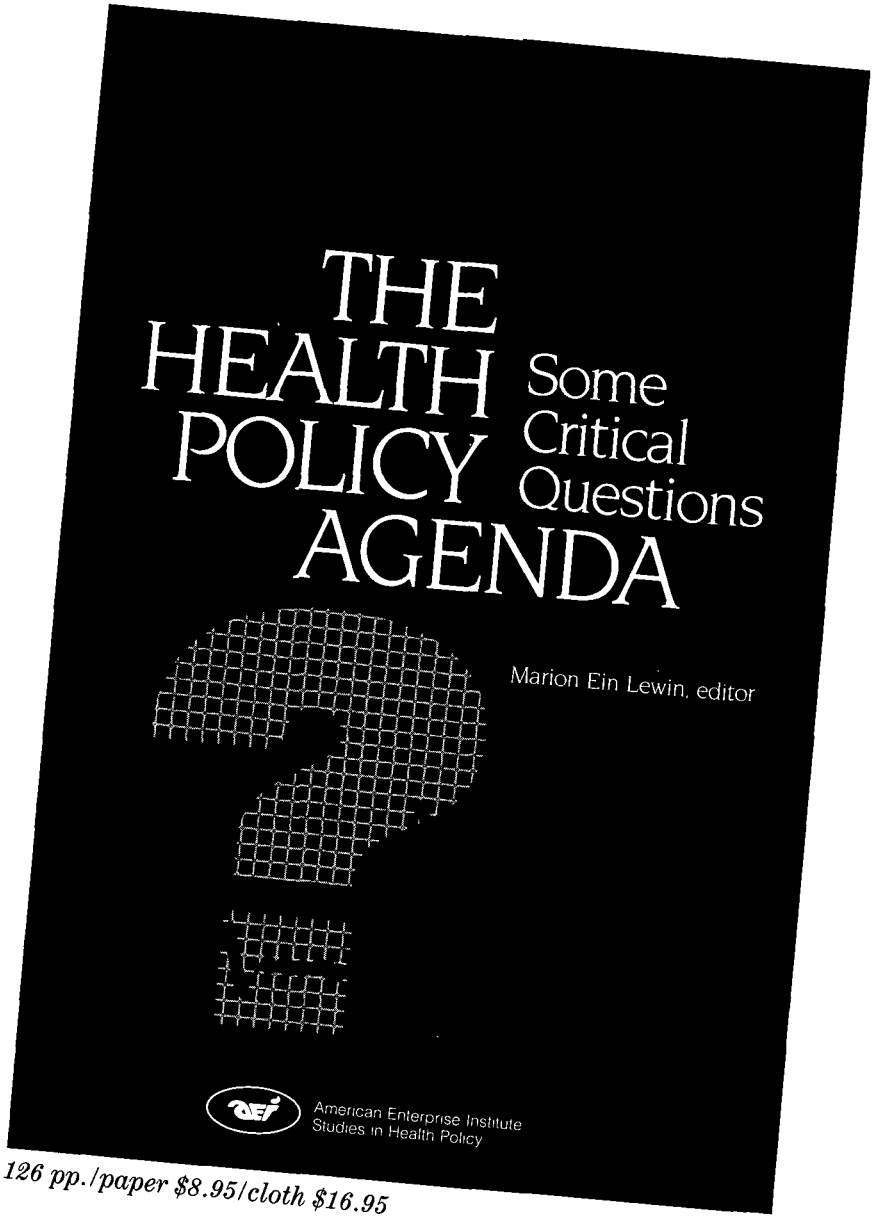

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